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A WILEY PUBLICATION IN ACCOUNTING

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FUNDAMENTALS OF AUDITING

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NEW YORK
JOHN WILEY & SONS, Inc.
London · CHAPMAN & HALL, Limited

Library of Congress Catalog Card Number: 54–12945

PRINTED IN THE UNITED STATES OF AMERICA

PREFACE

This book is intended for use in a first or elementary course in auditing at the undergraduate level; it is not proposed either as a review or a reference work for practicing public accountants.

The needs of undergraduate university students and of practicing auditors are considerably different because of the disparity in their experience and familiarity with field conditions. It is unlikely that any single work can serve both groups equally well. This book elects to serve college students who as a rule have little or no experience and a minimum of knowledge as to practices actually in existence. To that end it avoids lengthy treatment and excessive detail as these are of little value to the beginner in a new field. Instead it concentrates on the very fundamentals of auditing: the need for verification, the nature of audit evidence, the basic techniques for obtaining it, and the general application of those basic techniques in the more common situations.

The necessity and importance of the verification of accounting data and an appreciation of the basic techniques useful in performing verification should be brought to the attention of every student majoring in accounting. Further, he should learn that the methods or basic techniques of verification are the same for independent certified public accountants and for members of internal or government auditing departments. For that reason such specialized matters as the organization of a public accountant's office and problems of opinion writing are deferred until the student has an opportunity to grasp the real fundamentals of verification. Thus the book holds to its purpose of serving as a first course with opportunity for later specialization in either direction.

The theory under which *Fundamentals of Auditing* has been written is that in a first course at the advanced undergraduate level principles are more important than details, that an appropriate state of mind or attitude is as much a requirement for success in auditing as knowledge of procedures, and that a recognition of the usefulness and limitations of the basic verification techniques is essential to their intelligent use. To that end it presents in as simple language as possible the purpose, the requirements, and the basic techniques of auditing together with

sufficient application to the major problem areas of verification to permit development of an "auditing attitude" without stifling the beginning student with unnecessary and burdensome detail.

R. K. MAUTZ

Urbana, Illinois
November, 1954

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Chapter 1

AUDITING—ITS NATURE AND PURPOSE

A textbook intended for use in an introductory course in auditing probably should begin with a definition of auditing. Definitions, however, are seldom helpful unless they are simple and easily understood. An audit itself is neither simple nor easily understood; hence a definition of an audit must include words and phrases of a technical nature and meaning which tend more to confuse than to enlighten at this early stage. It is enough for the present to say that auditing is concerned with the verification of accounting data, with determining the accuracy and reliability of accounting statements and reports.

Probably the most important element of any audit is the auditor, the person who verifies the accounting data and then reports upon his efforts. By inquiring into his attitude, training, and procedures much can be discovered about what an audit is.

What Does an Auditor Do? An auditor is a professional man who makes an examination of accounting data in order to give his opinion as to the reliability of those data. Much has been written on the qualifications of an auditor, attributing to him in some cases the virtues of a saint and the wisdom of Solomon. Briefly, an auditor to be successful must possess the basic requirements of education, character, personality, and health required in any profession, plus something which for want of a better term we shall call "the auditing attitude." An auditor is much like any other professional person in his personal characteristics except that his vocational interest instead of being directed at law, medicine, education, or any other such area is directed at the verification of accounting data. Like any other professional man his native intelligence, ability for self-discipline, and ambition could probably carry him to some degree of success in any one of a variety of fields, but by inclination and training he has found his career to be in examining the truthfulness and dependability of accounting statements.

The Auditing Attitude. What is this audit attitude without which no man can attain real success in auditing? It is a combination of edu-

cation, experience, and judgment which provides a frame of mind, a point of view toward his work, that enables an auditor to appraise his problems accurately and to attack them effectively. It includes the following:

1. An understanding of the nature and usefulness of accounting and an appreciation of its limitations and weaknesses.
2. A knowledge of basic verification techniques, especially their applicability and usefulness.
3. Certain personal abilities and habits of thought without which items 1 and 2 would be ineffective.

Each of these requires some elaboration if it is to be fully understood and also in order that through a study of its implications one interested in a career in auditing can begin to develop within himself an audit attitude.

Accounting and Auditing Contrasted. As an aid to understanding the attitude that an auditor must develop it may be helpful to point out some of the differences between accounting and auditing. In the courses preceding this one and in many of those which follow this first course in auditing, the point of view must of necessity be considerably different. Accounting courses are concerned with taking the great mass of transactions entered into by a business concern during a period, and, through interpretation, summarization, and compilation, preparing financial statements explaining the results of those transactions in terms of profit and loss and current financial position. Accounting thus works with the original data and has the primary responsibility for bringing, out of the great number of data, useful financial reports. Accounting is thus primarily constructive; it works from the raw data forward to the finished statements.

Auditing, in contrast, is primarily analytical. When an auditor commences his work of verification the accounting work has largely been completed. It is the auditor's task to determine whether or not the financial statements already prepared by the accounting department or to be prepared from its general ledger balances, do a reasonable job of presenting the results of the company's operations. To do this he begins with the accountant's end product, the financial statements. These he then analyzes to determine their accuracy and reliability. This may call for working backward through the accounts and books of original entry to the underlying transaction documents; it may call for going beyond the accounting records to other evidence of the reliability of the financial

statements. In every case the auditor's question is: "Are the data in these financial statements complete, accurate, and presented fairly?" He is faced not with the raw data of transaction documents but with the results of someone's interpretation and summary of those data. Thus he must work back to determine whether or not the accountant's work has been satisfactory. In any given situation he may be working with statements and accounts that are well prepared and accurate or with records that are inaccurate and which violate many of the rules of sound accounting.

Inasmuch as his point of view and approach are different, it is not strange that an auditor must also develop a different attitude, an "auditing attitude," as mentioned in the preceding section.

General Nature of an Audit. In general, an audit seeks to establish the reliability or unreliability of the financial statements and supporting accounting records of a company or institution. That is, an audit is an effort to discover whether or not the financial statements do actually portray the financial position and the results of operations of the company or institution under examination.

For example, it seems reasonable that a merchandising or manufacturing business should have various fixed assets as well as current or working assets to carry on its business, and also it usually will have liabilities. During the course of operations the concern must incur expenses, will make sales, and expects to have a reasonable net income. In view of these facts, in auditing such a concern one should endeavor to determine:

1. Whether all assets acquired have been recorded on the books at a correct and reasonable figure. This means he must discover whether
   A. The working assets are valued in accordance with generally accepted accounting principles, and are reasonable in amount in view of the quality and quantity actually received.
   B. The fixed properties as they exist are properly reflected in the accounts, and the proper amount of depreciation has been charged to operations.
   C. All other supplies and services incidental to the welfare of the business and its operations that have been received or rendered to the business, and no others, are recorded on the books at fair and correct values.
2. Whether all assets parted with or liabilities incurred in the course of operations have been correctly recorded in the accounts.

3. Whether all assets, either commodities or services, going out from the business in the form of goods sold or otherwise and all liabilities incurred have resulted in an adequate increase in some asset or reduction of some liability.
4. Whether all assets acquired in each revolution of the business cycle have been used for the best interests of the enterprise.

If the auditor is to do these things successfully he must adopt the view that it is not sufficient to see that the respective assets and liabilities agree with the books. He should aspire to ascertain that all assets are "on hand" that should be "on hand" as a result of all the transactions that took place during the period under examination. This may be an ideal that is not attainable in many examinations, but the auditor should have it in mind and should attempt to reach it in so far as practicable. In doing so he will find it necessary to work with the nominal accounts that are related to various asset and liability accounts. This is essential because, except for correcting entries within the expense or income groups of accounts, every transaction that affects a nominal account affects also a real (balance sheet) account. To accomplish a thorough audit, one must recognize this relationship and use it as much as possible.

Need for Verification of Accounting Data. From previous courses in accountancy it should be evident that accounting is a device for collecting and presenting useful information about a business enterprise. It should also be recognized that accounting data may be in error for a variety of reasons, and that those who rely on accounting data frequently have no way of determining for themselves the reliability of the data presented. These ideas can be expressed somewhat differently to point out why verification is necessary.

First, business does rely on accounting data. Management in making decisions about expanding or reducing operations, in granting or withholding a bonus, in recommending for or against a dividend, and in a host of other important day-by-day decisions is influenced by accounting information of one kind or another. Banks and other sources of credit seldom advance funds or extend loans without first studying the applicant company's financial statements. Shareholders and other investors, whether acting individually or through an investment service, are influenced by reports of earnings and financial condition. In an economy in which credit transactions make up a majority of all business done, accounting reports of one kind or another are of prime importance in providing a basis for doing business.

Second, accounting data are subject to error. Before the transactions for any day are assembled, classified, and summarized they pass through the hands of several employees. Notwithstanding the modern widespread use of office machines, many errors, either of omission or commission, can arise in the course of a month or year. Furthermore, the accounting data for any enterprise are obtained and issued under the direction of the management of that enterprise. Such human operation, control, and exercise of authority can result in what are known as intentional errors. Such "errors" usually are associated with personal gain to the individual at the expense of the business entity. Examining further into the source and nature of errors, these basic ideas can be expressed in more detail in the categories following:

1. Ignorance, on the part of accounting department employees, of generally accepted accounting principles, of appropriate account classifications, of the necessity for reconciling subsidiary ledgers with controlling accounts, and of good accounting practice in general.
2. Carelessness on the part of those doing the accounting work.
3. A desire to conceal the effects of defalcations or shortages of one kind or another.
4. A tendency by management to permit prejudice or bias to influence the interpretation of transactions or events or their presentation in the financial statements.
5. An ever-present desire to hold taxes on income to a minimum.

If, then, accounting data are subject to error from a variety of sources and for a variety of reasons, and at the same time we find it necessary to use accounting data in making business decisions, we are faced with something of a dilemma. The obvious solution, of course, is to require that the accounting data prepared by an accounting department be verified by an independent reliable party and bear his stamp of approval before being accepted as reliable. The profession of auditing has evolved to perform this service. Experts of proven dependability in accounting matters are employed to examine the reported data and to give an opinion on the accuracy and reliability of those data.

Two quite different groups are active within this general field of auditing. Internal auditors are employees of the company or enterprise whose records they examine. They in effect stand between the accounting department staff and management to assure the latter that the accounting department is functioning as it should and that its reports are accurate. Independent auditors, or independent public accountants

as they are generally known, are not directly affiliated with the companies or enterprises whose financial statements they examine. They are independent contractors who, after adequate examination and investigation, offer a professional opinion as to whether the concern's financial statements which they have examined present fairly the results of operations and the financial condition of the enterprise. In effect they stand midway between the enterprise and other interests which use its accounting data. Thus to some extent they report on management's influence on accounting data as well as on the accounting department.

There are some extremely important differences between internal and public auditors, but in so far as verification methods and procedures are concerned the differences are not significant and can be left for later investigation. At this point our interest is with such fundamentals as the need for verification of accounting data and the ways in which verification may be accomplished, regardless of who does the work.

Types of Errors in Accounting Data. Once the need for verification has been established, the types or kinds of errors that may be present in the data should be considered. It is well enough to know that errors are a definite possibility, but unless one has a sound understanding of the nature and effect of different kinds of errors it is entirely possible that significant errors might be overlooked or not recognized for what they are. Errors could be classified in a variety of ways but for purposes of becoming familiar with their basic characteristics, the following features seem most important. It will be apparent that the term error is used here with an extremely broad connotation to include not only mistakes but also any failure of the records to state what actually took place. With this idea of errors in mind, they can be described as:

1. Self-revealing and not self-revealing.
2. Unintentional and intentional.
3. Unconcealed and concealed.
4. Affecting general ledger balances and not affecting general ledger balances.

Each of these classes may require some explanation.

Self-Revealing and Not-Self-Revealing Errors. The nature of the double entry bookkeeping system in general use is such that certain kinds of errors are brought to light almost automatically. For example, failure to post a part of a journal entry to the ledger is, of course, an error and is one that would be revealed when a trial balance was prepared. An

incorrect total for the cash column in a columnar cash receipts book, unless balanced by incorrect totals for other columns as well, would result in unequal debits and credits being posted to the general ledger. Such an error also should be revealed when a trial balance is prepared.

The use of controlling accounts and subsidiary ledgers likewise assists in locating and bringing to light certain errors. If all sales on account are entered in a sales record which is posted in total to Accounts Receivable and in detail to the subsidiary accounts receivable ledger, any errors made in posting to the subsidiary ledger or in totaling the sales for the period should cause the subsidiary ledger to be out of agreement with the controlling account. Similarly, any failure to post an item of cash received on account to the individual customer's account as well as to the controlling account in the general ledger through totals for the month would result in disagreement between subsidiary ledger and control.

Certain business practices that tie in with the accounting system but that are not generally considered to be a part of it may also be effective in revealing certain types of errors. The preparation of a bank reconciliation, for example, should discover any errors made in entering checks which have cleared the bank before the date of the reconciliation, any failure to record as a cash disbursement a check which has cleared, any failure to deposit cash receipts which have been entered in the cash receipts book, and similar differences between the book records and actual cash transactions.

Again, the practice of sending monthly statements of account to customers may help in finding errors not otherwise easily discovered. For example, a remittance received from one customer might inadvertently be posted to the account of another customer. Such an error would not destroy the agreement between subsidiary ledger and controlling account and so would not be discovered by taking a trial balance of the subsidiary ledger. If monthly statements are sent to customers it is likely that one or both of the customers whose accounts are affected will communicate with the company to point out the mistake.

Thus, certain errors are revealed almost automatically by double entry accounting procedures and others by following established business practices. Other errors, however, are not revealed by either of these possibilities. If an item of expense which should have been charged to Salesmen's Travel Expense is posted incorrectly to Advertising, there is very little possibility that the mistake will be brought to light through the ordinary accounting procedures. Likewise, if an item of machinery

repair is charged to a fixed asset account instead of to an expense account, or if the amount of depreciation is calculated incorrectly, there is nothing in the bookkeeping system which will bring the error to attention. Such mistakes may remain undetected indefinitely unless measures aimed specifically at discovering such errors are applied; they are in no way self-revealing.

Unintentional and Intentional Errors. The meaning of these terms is clear. An unintentional error is any mistake made without intent, no matter how it may have been made. Intentional errors are, of course, made deliberately, and it follows that there is an intent to deceive, to mislead, or at least to conceal the truth. It follows that, other things being equal, they are more serious than unintentional errors because of the implication of dishonesty which accompanies them.

A great variety of intentional errors may be found. They range from efforts to conceal one's ignorance or incompetence, on through the coverage of petty thefts of cash or merchandise, and to such things as major defalcations and untruthful financial statements issued to outsiders. General ledger bookkeepers who were unable to obtain a trial balance have been known to "force" one; cost accountants unable to explain the composition of variance account balances have sometimes misstated the nature of such items; petty cash custodians have forged vouchers to cover their thefts; incorrect footings in books of original entry and in ledger accounts have been employed to conceal shortages of cash on hand or intercepted receipts; overstated inventory quantities and improperly classified asset and liability items have been used to "improve" the current position in balance sheets issued for credit purposes. These and many other possibilities suggest themselves to anyone in difficulty, and verification procedures must be studied with such possibilities in mind.

Students of auditing sometimes receive the impression that intentional errors and their discovery are given far too much attention, that auditors tend to become too suspicious and consider everyone dishonest until proved innocent. It should be remembered that out of long and sometimes unfortunate experience auditors have developed the point of view or attitude which they know is essential if they are to discharge their responsibilities adequately. They have learned that intentional errors are in general more difficult to discover than unintentional errors. Hence, *if they direct their procedures at discovering the more difficult intentional errors they are reasonably certain to locate the more simple and far more common unintentional errors on the way.*

They have learned too that, although most people are honest, under certain circumstances many may be tempted. A person in a position of trust and responsibility who feels he is well paid for his efforts, who has no pressing need for additional funds, and who knows he will surely be discovered if he tampers with the company's cash is probably a very safe risk. But if the situation is changed so that he feels he is not adequately compensated for the responsibilities assigned to him, if he has real need for additional funds because of illness in the family or expensive personal habits, if he is in such a position that he can "cover" his peculations, then we have quite another possibility.

Few people ever start out with the deliberate intention of stealing their employer's resources. They may, however, through force of circumstances be encouraged to "borrow" temporarily. If successful, temporary borrowing may be extended until eventually the borrower finds himself unable to repay.

An auditor who is not fully aware of the possibilities of intentional errors and the potential danger in giving any individual complete control over valuable resources lacks a vital part of the attitude he must have for success in his field.

Concealed and Unconcealed Errors. At first thought one might conclude that all intentional errors would be concealed; such, however, is not the case. A check drawn on a company bank account to provide funds for personal use by an officer or employee may be charged to some expense account and then left with the other paid checks under the assumption that it will never be examined anyway. Cash receipts which were intercepted and used for personal expenditure may be entered properly and no attempt made to conceal the shortage because no one ever examines the bank reconciliation except the person responsible for the defalcation. Concealment thus may be omitted because the perpetrator feels it is unnecessary and also because he is unable to work out an effective method of coverage.

On the other hand, many opportunities exist for successfully covering a shortage and for making improper disbursements appear legitimate. These opportunities vary from company to company, and their discovery sometimes requires the exercise of considerable imagination by the auditor. A few simple examples may serve to illustrate.

Let us assume a situation in which cash collected from customers as receipts on account has been intercepted and used for personal needs. Let us assume further that the guilty party knows he must enter the cash

receipts properly in order that the accounts receivable bookkeeper may post credits to the accounts of the customers concerned. Otherwise, there will be complaints when the customers receive their monthly statements and his failure to enter the cash received will be uncovered. Because he must enter the cash receipts, however, he is in difficulty; the cash account per books will be debited for cash which never reached the bank. Therefore, when a bank reconciliation is attempted at the end of the month the balance per bank will be less than the books indicate should be there.

Provided that he has access to the necessary records and papers, several possibilities suggest themselves:

1. If he prepares the bank reconciliation, he can understate the

Temporary and Permanent Concealment. A difference among the methods of concealment suggested above should be pointed out. The first suggestion, manipulation of the bank reconciliation, differs from the others in that it merely appears to conceal the shortage; no attempt is made to reduce the general ledger balance of cash to agree with the bank figure. Therefore, the discrepancy will require coverage again in the following month. All the other methods are aimed at changing the cash account balance to agree with the cash actually in the bank. Once this is accomplished, the shortage is covered "permanently"; that is, there is no need to repeat the coverage in the following month unless additional amounts are intercepted.

Permanent coverage then requires alteration of general ledger account balances to agree with the actual situation as it exists after the improper transaction has taken place. Temporary concealment includes any measures which do not "adjust" the general ledger balances concerned.

Needless to say, the term permanent concealment does not imply coverage of such nature that the error can never be found. Few errors, if any, escape a resourceful auditor permitted to employ all procedures he considers necessary.

Errors Not Affecting General Ledger Balances. Sometimes we become so preoccupied with the general ledger and its supporting records that we neglect other important features of the accounting system. An accounting system includes both records and procedures. Errors can appear in either or both. We have already discussed some of the errors which affect general ledger balances; now let us give some brief consideration to errors which do not. For want of a better title we shall call these "procedural" errors.

The sales procedure of a company may include the following steps:

1. Receipt of order from salesman.
2. Review of order by credit department to determine whether customer should be given credit as requested.
3. Clearance with inventory department to be sure that goods requested are on hand.
4. Preparation of invoice with copies to serve as acknowledgment to customer, shipping order to shipping department, billing copy to accounting department, and invoice to be mailed to customer after shipment.

If the procedure requires that these steps be taken in the order indicated and if for any reason the second step is omitted, or is not completed

before the subsequent steps have been taken, an error in procedure has been made.

Procedures are established to maintain control over resources and over transactions; any failure to follow the procedures set up lessens the control and may permit errors which do affect the ledger accounts. Any breakdown in established procedure thus suggests not only the presence of a procedural-type error but also of other possible types.

Other errors of this type include the approving of transactions or documents by someone other than the person authorized to do so, failure to insure that all preceding steps have been performed before approving a document, and substitution of one person for another temporarily during the noon hour or a "break" unless such substitution has been authorized. An auditor must concern himself not only with accomplished errors but also with any weakening of controls which may permit or even encourage errors in the future.

Possibilities for Errors. A knowledge of the kinds of errors is not sufficient unless it is accompanied by an awareness of where errors are most likely to occur in the accounting process. To verify accounting data means, at least by implication, to assure that no errors have been made or that those which have been made have been corrected. In either case, one must know where to look to discover if errors are present.

Three general areas of error possibility deserve attention. They are:

1. Transaction recording.
2. Bookkeeping procedures.
3. Financial statement preparation.

Each of these in turn must be subdivided somewhat to show the extent to which accounting data are susceptible to error.

Transaction recording is basic to the collection and summarization of financial information. The opportunities for incorrect accounting in this area include:

(*a*) Improper transaction analysis.
(*b*) Omission of transactions which should be included.
(*c*) Inclusion of transactions which should be omitted.

The possibilities for improper transaction analysis are apparent. Resolving any transaction into debits and credits to be posted to the general ledger makes possible the selection of an inappropriate account to be debited, an inappropriate account to be credited, and use of an incorrect

amount. As transactions become more complex, the opportunities for mistaken entry increase.

Among the more common errors made in transaction analysis is that of failing to distinguish between asset and expense items. Repair and maintenance charges are sometimes debited, incorrectly, to asset accounts, and legitimate additions to fixed assets are sometimes carried to expense accounts. Such errors more often than not are unintentional, but it is certainly within the realm of possibility that a profit-sharing bonus plan on one hand or federal income tax considerations on the other might induce a controller or business executive to adopt a liberal or conservative policy on the subject of fixed asset additions.

Omission of transactions which should be included also covers a wide variety of possibilities. Illicit expenditures or intercepted receipts may be omitted from the record entirely. On the other hand, negligence or unawareness of the necessity for care at the end of the fiscal year may result in a failure to record transactions which should be included within the year. For example, material ordered during the year may be received late in December, placed in stock, and included in the physical inventory taken as of December 31. If the invoice from the supplier is not received and entered until early January, however, we have an obvious error. The December 31 inventory includes merchandise never entered as a debit to Purchases and as a credit to Accounts Payable during the year. This will result in an understatement of the cost of goods sold and an overstatement of net income for the year, as well as in an understatement of accounts payable.

A similar but less serious error might result from failure to include a shipment of purchased merchandise in transit at the year end to which title has passed upon shipment. Such merchandise should be included both in purchases and the ending inventory so the error would have no effect upon net income. It should also be included in both inventory and accounts payable in the balance sheet and, if sufficiently material, might influence the current ratio. This may be illustrated as follows, using an unlikely example merely to emphasize the point.

	Current Assets	Current Liabilities	Current Ratio
Before considering goods in transit	$10,000.00	$ 5,000.00	2 to 1
Purchased goods in transit	5,000.00	5,000.00	
After considering purchased goods in transit	$15,000.00	$10,000.00	3 to 2

Transactions included within the year which should be omitted might be completely fictitious ones entered for any one of a variety of reasons. They might also be transactions rightly belonging in another year entered in the current year through failure to segregate carefully the transactions of the two years. It is not uncommon, for example, for some companies to record the cash receipts of, say, January 2, 3, and 4 as if they were received December 31, in order to present a stronger cash position at December 31. In the same way, sales might be entered in advance of actual shipment, or payments on accounts payable might be entered although no checks had actually been mailed. The latter practice results in deducting equal amounts from cash and accounts payable, thereby improving the current ratio.

These are but some of the errors which may be made in the process of recording transactions. They do, however, give an indication of the extent and types of possibilities in that area.

Bookkeeping Procedures. Once transaction recording has been completed, the mechanics of bookkeeping consist largely of accumulating, transferring, offsetting, and combining figures; it is made up largely of arithmetical computations and various transfers of figures.

Every computation, of course, constitutes a possibility for an incorrect result and therefore for an error. The footings and balance of every ledger account, the footings and cross footings of columnar books of original entry, calculations of depreciation, bad debts, interest, discount, and bonuses, extensions and footings of inventory pages, and any other point at which computation is necessary increase the opportunity for errors.

Likewise, wherever a figure is forwarded from one place to another a possibility for error exists. One thinks immediately of posting, and this is indeed a real possibility, but there are others as well. The forwarding of page totals in a columnar book of original entry, preparation of a trial balance and of work sheets, inventory listings prepared from inventory tags, and financial statements prepared from a trial balance or work sheet all require that amounts be recopied. Any point at which this is necessary provides another possibility of error, either deliberate or unintentional.

Financial Statement Preparation. In the preparation of financial statements, errors may be made in:

1. Improperly including items or amounts.
2. Excluding items or amounts.
3. Inadequately or inaccurately describing items.
4. Failing to make full disclosure.

The overstatement of individual assets, the inclusion of resources which have no place in the concern's balance sheet, the inclusion of fictitious or perhaps unrealized revenue, and the exclusion of liability or expense items are all real possibilities. However, the more common types of error in financial statements have to do with improper description or classification of certain items.

Many bond indentures and other loan agreements place considerable stress on the current ratio. Maintenance of a good current ratio is therefore of considerable importance. When a given item appears to be on the line between current and other assets or between current and fixed liabilities, its appropriate classification may be at once very difficult and very important.

Likewise, the description of advances received from customers if those advances are ringed with restrictions, advances to affiliated companies, and amounts due to or from officers and employees require precise and clear wording.

The problem of presenting sufficient information is difficult too. Contingent liabilities, for example, must be disclosed without at the same time appearing to recognize the liability as a real one, thereby giving opposing attorneys or revenue agents a strong argument. Disclosure of transactions between a company and its officers should be required but is often difficult to obtain in traditional financial statements.

It will be noted too that errors in this general area are often more difficult to establish as errors than are those discussed in the preceding sections. If a column of figures has been added incorrectly, this fact can be demonstrated readily. To convince someone that a description in the financial statements is misleading or that additional information should be presented is another matter. These latter matters tend to be questions of opinion and are therefore sometimes much more difficult to deal with. An auditor, however, is presumed to have a substantial foundation in accounting theory and practice. He should be able not only to determine that an item has been treated improperly in the financial statements but should be prepared to defend his position as well.

From the discussion in this chapter it should be apparent that errors in accounting data are possible and therefore that such data require verification if they are to be depended on in the making of business judgments. The purpose of this chapter has been to point out the necessity for verification of accounting data by showing in a general way how, where, and why errors may enter into such data. At the same time it has attempted to aid the student to acquire an auditor's attitude by offering convincing proof of the need for thorough and careful application of verification procedures if actual errors are to be discovered.

CORRECTION OF ERRORS

Once an error has been discovered, the auditor must determine whether correction is necessary and, if so, the method of correction to be used. The thought that an error might go uncorrected may come as something of a surprise, but there are many errors which are of such a nature or are so immaterial that correction is passed as unnecessary. A mistake in charging a minor expense item to the wrong account may have so little effect upon the balances of the two accounts concerned that correction is not in order. Also, there are errors of procedure that do not affect account balances. If a required internal control step is being omitted or if a series of steps are being taken in the wrong order, little good can come from correcting past performance. In such cases, as with incorrect expense classification, all that need be done is to point out to the individuals responsible the nature of their errors so that mistakes will not be made in the future.

Much of an auditor's work can and should be of a preventive nature. If he can locate weaknesses in internal control, errors in expense distribution, or similar faults before any serious errors are made and suggest remedies, he can often be of far more service than if he spent the same amount of time looking for errors already made.

But what of serious or material errors which have been made? In general these should be corrected and should be corrected in accordance with good accounting practice. As we have seen, errors are of a wide variety; naturally all of them will not be corrected the same way. From the standpoint of correction, errors can be divided into two main groups: those that affect the balances of general ledger accounts and those that have not yet or never will affect general ledger account balances. For example, an error in pricing the physical inventory quantities will cause an incorrect total for the inventory. If this error is discovered before

the ending inventory amount is entered, the inventory total can be changed and the correct amount entered. The error was discovered before it reached the general ledger accounts. If, however, the incorrect inventory total had been entered in the accounts so that the balance of the Inventory and Cost of Goods Sold accounts were in error, then a different method of correction would be required. Once an error has been entered in the general ledger it should be corrected only by journal entry. That is, a special correcting journal entry should be prepared to increase and/or decrease the proper account balances. The entry should be recorded in the general journal together with a complete explanation and then be posted to the ledger.

The reason for this method of correction of errors in the general ledger should be apparent. The alternative to such correction is to merely cross out or erase the incorrect amounts and write in the correct ones. A general ledger corrected in this way would be full of questionable changes with no explanations. A complete journal entry, on the other hand, gives a satisfactory explanation of the error and of its correction.

Most errors requiring correction do reach the general ledger before discovery and thus require correction through journal entry. This is true because most verification work is attempted after the bookkeeping has been completed. If an error were made in footing the cash receipts book and discovered before the book was posted to the ledger it could be corrected merely by changing the total of the cash receipts record itself and then posting the corrected amounts. If the posting has been completed, however, then a journal entry correction is needed because the error has been carried into the general ledger.

Correcting Entries. In preparing correcting journal entries, an auditor must remember that the completed entries are in the nature of a public relations device. If he gives to the bookkeeping department a long list of debit and credit entries with no explanations he is almost certain to receive a host of questions and critical comments. No one likes to be told that his work is wrong and that it must be corrected. Much more, no one likes to be told that his work is wrong without any explanation of how or why it is wrong.

Every journal entry should carry an explanation of the debits and credits in the entry. This is particularly true of correcting entries. The person whose work is being corrected by means of the entry should be able to tell from the entry exactly what error he made and therefore

why the entry is necessary. The two following entries may help to point up the problem.

— 1 —

Furniture and Fixtures	$125	
Miscellaneous Office Expense		$125
(To correct.)		

— 2 —

Furniture and Fixtures	$125	
Miscellaneous Office Expense		$125
(To capitalize cost of steel office file charged to expense on voucher number 7-342.)		

In so far as the effect upon the ledger accounts is concerned, these two entries are the same. The second, however, is much to be preferred in that it provides an adequate explanation of why the correcting entry is necessary and is therefore less likely to irritate those with whom the auditor must work.

A second important point about correcting entries is the very obvious one that they must correct the error that was found by the auditor. When an error is found, the auditor is in a different position from the person who made the entry originally. That person had but to analyze the transaction and prepare an entry accordingly. The auditor must analyze the transaction, next give consideration to the entry already made, and then proceed to make an entry which will at once counter any incorrect debits and credits that have been made and at the same time get the correct account balances. Assume, for example, that a partially depreciated fixed asset was retired and the transaction recorded by the following entry:

Earned Surplus	$ 75	
Accrued Depreciation on Machinery	735	
Cash	180	
Machinery		$990

Upon investigation the auditor finds that the accrued depreciation at the date of retirement should have been $670 and that the entry is therefore in error. Further, let us assume that this company has a special account to receive gains and losses on the retirement of fixed assets so that the Earned Surplus account should not be charged or credited directly for such items. The auditor must then reason out the entry that should have been made, study the entry that was made, and derive from these the entry necessary to get from the first of these to the second.

The entry that should have been made is as follows:

Loss on Retirement of Machinery	$140	
Accrued Depreciation on Machinery	670	
Cash	180	
Machinery		$990

However, it would be incorrect for the auditor merely to make an entry to record the original transaction. Such an entry has already been made, and the auditor must not repeat any part of it. Instead he must decide which parts of the original entry are right and let them stand, and which parts are wrong and need correcting. From the entries given it is apparent that the following entry is needed to correct the errors made in the first entry.

Loss on Retirement of Machinery	$140	
Accrued Depreciation on Machinery		$65
Earned Surplus		75
(To correct entry made Nov. 18, 1954, for retirement of machine #712.)		

This appears to be an extremely simple point, but it is frequently overlooked, and unsatisfactory correcting entries may therefore be made. Needless to say, an auditor whose correcting entries fail to accomplish their purpose has some difficulty in reestablishing his reputation.

Correcting or adjusting entries should always make use of the account titles in the company's ledger unless there is a deliberate intention to add a new account. One should never use a Miscellaneous Office Expense account in a journal entry, for example, unless the company concerned has such an account in its ledger. The bookkeeper who is told to enter the auditor's adjusting entries will in most cases follow them exactly as given, and if he finds no such account in the ledger will establish new ones to receive the adjustment. This can result in needless confusion and should be avoided by selecting carefully the account titles for journal entries.

Finally, adjusting or correcting entries should never be made to the Profit and Loss account. In accounting discussions we frequently use such expressions as "Charge it to Profit and Loss." What is actually meant is "Charge that to an expense account which will be closed to Profit and Loss." The only time entries are ever made directly to the Profit and Loss account is when the books are closed at the end of a fiscal period. Profit and Loss is a special account used only in closing the books. All transactions are entered into asset, liability, income,

expense, or net worth accounts, and any corrections of entries made to record transactions should likewise be made to such accounts.

Types of Correcting Entries. The correcting journal entries recommended by an auditor on the basis of his examination are of various kinds and call for different treatment. For example, they may be divided into two groups: "adjusting entries" and "reclassifying entries." Under this classification, adjusting entries are those that must be recorded for their permanent effect on the accounts, generally because they affect the amount of profit for the period. As an illustration, discovery by the auditor of an amount charged to a fixed asset account that should have been charged to Maintenance and Repairs calls for an adjusting entry increasing Maintenance and Repairs and decreasing the fixed asset account balance. Such an entry should be made in the accounts so that the profit for this period and the balance sheet accounts for this and future periods are correct.

Reclassifying entries are those which must be made in order to obtain correct financial statements this period but which are not essential to correct statements in the future. An erroneous classification of an expense item as Advertising instead of Travel and Entertainment calls for an entry by the auditor so that the final balances of these accounts are correct for reporting purposes. However, the entry in no way affects future periods nor the profit for this period. If it were not actually made in the company's accounts, no serious consequences would follow. As another example, assume that the company has made an advance to an affiliated company, which advance it considers an account receivable. The amount is included in the balance of the controlling account and has a separate sheet in the subsidiary accounts receivable ledger. The auditor will probably transfer this amount to a special account so that it will not be overlooked when the balance sheet is prepared. It is not an ordinary trade receivable and so should be disclosed separately. Except for this the company's accounting may be entirely satisfactory.

Auditors frequently make two lists of adjusting entries: first, those which, after the examination is completed, will be given to the bookkeeper with the recommendation that the entries be recorded in the accounts; and second, those which are prepared only for the purpose of obtaining correct classification within the financial statements and which the company's accountants need not record.

The line between adjusting and reclassifying entries is not always an easy one to distinguish. This is partly because all reclassifying entries could be recorded as adjusting entries if desired. In most situations,

however, to relieve the bookkeeping department of dealing with any more entries than necessary, they are made by the auditor for work sheet purposes only.

A further subdivision of adjusting entries should be recognized. Certain adjusting entries should be reversed as of the beginning of the following period; others may be permitted to stand. The erroneous classification of a repair item calls for an entry that will stand without reversal. An example of the other type is found in a situation in which an invoice for goods shipped F.O.B. destination was not entered as a purchase until the following period although the goods were received before the year end and included in inventory. An adjusting entry is required to take up the amount of the purchase in the right year; this entry must then be reversed as of the first day of the following period to offset the entry already made in the invoice record so that the purchase is not entered in the ledger account balances twice.

In giving a list of adjusting entries to a bookkeeping department, an auditor should carefully indicate those that call for reversal. Otherwise an unsuspecting bookkeeper may have considerable difficulty in arriving at correct account balances in the second year.

Adjusting Entries When Books Have Been Closed. One additional point should be made with respect to adjusting entries. It has become customary for an accounting department expecting an audit examination to leave its books open until the examination has been completed. It will foot, rule, and post its books of original entry and will start fresh pages correctly dated for transactions of the following year. It may and should record all regular adjustments for accrued, deferred, and estimated items. Generally it does not make any closing entries, however. Therefore it is possible to record the auditor's adjustments, no matter how late the examination is completed, before closing.

In some cases, however, the books have been closed before the auditor completes or perhaps even commences his examination. This presents something of a problem. The auditor will proceed to take off a trial balance for work paper purposes as if no closing entries had been made, will prepare adjusting and closing entries, and will post them to his work sheets so that appropriate balances result. When the time comes to give a list of adjusting entries to the client, he must recognize that the nominal accounts for the year under review have been closed through Profit and Loss to Earned Surplus. Therefore any entries affecting nominal account balances must be debited or credited to Earned Surplus or the account used for that purpose, although for analytical purposes the ap-

propriate nominal account titles may be shown parenthetically or in the explanation.

Other Contributions of the Auditor. It should not be concluded from the preceding discussion of errors and their correction that an auditor does nothing but search for and correct errors. To be a competent auditor one must first be an expert accountant. As an auditor proceeds with his study and analysis of the accounts, procedures, and activities of a company under examination he should be alert to opportunities to make suggestions for improvements in its record keeping, internal control, and operating procedures. Because of the nature of his work an auditor generally obtains a broad background of experience with a considerable variety of companies and situations. At every opportunity he should make use of that experience to develop suggestions for the improvement of the accounting system under examination. Frequently suggestions for such improvements do more to convince others of the professional caliber of the auditor's work than any other feature of his examination.

PROBLEMS—CHAPTER 1

Problem 1–1. The Gordon Manufacturing Company has a small office staff. R. T. Linder, the accounts receivable bookkeeper, receives all letters containing currency or checks from the switchboard operator who opens the mail. He then prepares a list of the amounts received each day, from which he posts to the accounts receivable. He also prepares the bank deposit at the end of the day for the day's receipts. After posting from his remittance list to the accounts receivable ledger, he forwards the list to the head bookkeeper, who uses it in making a summary cash book entry for the day. If Linder abstracted $50 from currency received on account, in what ways might he cover the shortage?

Problem 1–2. What various unintentional errors might cause a subsidiary accounts receivable ledger to be out of agreement with the general ledger control account? Which of the errors would you search for first? Which would be most easy to locate?

Problem 1–3. State the ordinary bookkeeping or accounting procedure that might be expected to locate each of the following errors. If you feel the error would not be discovered in the ordinary course of the accounting work, so state. Be specific in your answers.

1. A check for $150 was entered in the check register as $15.
2. In footing the check register, the cash discounts column was underfooted $100.
3. A check received on account from R. C. Maltz was posted to the account of R. T. Maltz.
4. In transcribing quantities from physical inventory count tags to the inventory lists, a quantity of 10,000 brass fittings was incorrectly copied as 1,000.
5. A sales invoice for $210 to C. M. Jones slipped off the billing clerk's desk into the waste basket and was destroyed. Sales invoices for that day had already been totaled and entered in the sales book but had not been posted to Accounts Receivable.
6. In listing the purchase invoices to be included in the adjusting entry to record accounts payable at the end of the year, an invoice for $1,500 was inadvertently omitted.
7. In calculating the net payroll, an error in the footing was made so that $200 was deposited in the imprest payroll bank account in excess of the sum of the individual checks to be issued.
8. When posting from the cash receipts book, the total of the sales discount column was posted to the debit side of the Purchase Discount account.
9. In posting individual items from the miscellaneous column of the

voucher register, a debit to Miscellaneous General Expense was posted to Miscellaneous Selling Expense.

10. In recording the retirement of an office adding machine, the accrued depreciation was calculated and entered as $240; it should have been $290.

Problem 1–4. The current section of the balance sheet of the D-F Corporation appears as follows:

D-F CORPORATION

BALANCE SHEET—DECEMBER 31, 1952

Cash		$ 15,000	Accounts payable	$24,000
Accounts receivable	$40,000		Notes payable	35,000
Less estimated uncollectibles	3,000	37,000		
Inventories		85,000		
Prepaid expenses		5,000		
		$142,000		$59,000

The following errors in the company's accounting are discovered:

1. Sales for the first three days in January 1953 in the amount of $13,000 were entered in the sales book as of December 31, 1952. Of these, $11,500 were sales on account and the remainder were cash sales.

2. Cash collected in January 1953 and entered as of December 31, 1952, totaled $15,192. Of this amount, $10,192 was received on account after cash discounts of 2% had been deducted; the remainder represented the proceeds of a bank loan.

3. January 1953 cash disbursements entered as of December 1952 included payments of accounts payable in the amount of $18,500, on which a cash discount of 2% was taken.

4. The inventory included $12,000 of merchandise that had been received at December 31 but for which no purchase invoices had been received or entered. Of this amount, $5,000 had been received on consignment; the remainder was purchased F.O.B. destination, terms 2/10, n/30.

Required: (1) Restate the current section of the balance sheet in accordance with good accounting practice. (2) State the net effect of your adjustments on the *D-F* Corporation's surplus account.

Problem 1–5. Each of the following items describes an error made in accounting by the Sadd Company during 1952. For each error, prepare an adjusting entry to correct the accounts.

1. Consignment shipments of stock that cost $12,000 were entered in the sales book as regular sales at a uniform mark-up of 40% on cost, which is the selling price the consignee is to use. On December 28 an account sales was received from the consignee containing the following information:

Sales to date		$15,120
Less:		
Freight and handling	$ 450	
Consignee's commission	1,512	
Uncollected accounts	8,000	9,962
Balance remitted herewith		$ 5,158

The company made the following entry to record the information in the account sales:

Cash	$5,158	
Freight and Handling	450	
Commissions on Sales	1,512	
Accounts Receivable		$7,120

2. A delivery truck purchased July 5, 1948, for $2,100 was traded in April 12, 1952, on a new truck listed at $2,800. Cash in the amount of $1,600 was paid in settlement. The company's policy is to depreciate all delivery equipment over a five-year life with no scrap value considered. Depreciation is computed to the nearest full month and entered only at the end of the year for all assets held during the year. The entry made for the transaction was:

Delivery Equipment	$2,800	
Loss on Retirement of Delivery Equipment	375	
Accrued Depreciation on Delivery Equipment		$1,575
Cash		1,600

3. New shelving constructed in June 1950 in a warehouse under lease for 40 years was charged to Warehouse Expense in the amount of $620. It is expected that the shelves will last 10 years. The error was not discovered until December 1952.

4. On July 1, 1952, the company had certain of its fixed assets appraised as follows:

	Per Books before Appraisal	Per Appraisal
Land	$100,000	$ 180,000
Buildings	600,000	1,000,000
Reserve for Depreciation, Buildings	150,000	200,000

These assets were acquired July 1, 1942. To record the appraisal, the company made the following entry:

Land	$ 80,000	
Buildings	400,000	
Reserve for Depreciation, Buildings		$ 50,000
Surplus		430,000

On December 31, 1952, depreciation was recorded in this manner:

Depreciation of Building	$ 20,000	
Reserve for Depreciation, Buildings		$ 20,000

Problem 1–6. During the month of November 1952, the cashier-bookkeeper had misappropriated a considerable amount from the Kuhn Construction Company and had covered it by depressing the cash account balance to agree with the cash balance per bank statement. This was accomplished by overstating footings in the check register and by understating footings in the cash receipts book as follows:

Check Register	Correct Footings	Incorrect Footings
Cash	$68,217	$73,217
Purchase Discount	812	812
Accounts Payable	35,215	35,215
Miscellaneous		
Direct Labor	18,740	20,740
Indirect Labor	6,710	7,710
General Expense	4,590	5,590
Selling Expense	3,774	4,774

Cash Receipts Book	Correct Footings	Incorrect Footings
Cash	$75,820	$73,520
Sales Discount	916	1,916
Accounts Receivable	69,400	69,400
Cash Sales	7,336	6,036

Prepare a journal entry or entries to correct the accounts. Assume that the total amount of the shortage can be charged to a special account receivable from the bonding company.

Problem 1–7. You have been employed to make an audit for the first time of the Crawford Corporation for the year ended December 31, 1952. Your investigation of the single prepaid expense and deferred charge account disclosed the information given below.

You are required to prepare the adjusting journal entries necessary to correct each individual item if, in your opinion, an adjustment is necessary.

Prepaid Expenses and Deferred Charges

	Debit
1. Interest (Interest paid in advance on a $30,000, one-year, 4% note, dated October 31, 1952, to the First National Bank.)	$1,200.00
2. Accounts receivable (This represents an entry of September 30, 1948, made to the credit of the accounts receivable controlling account for the purpose of agreeing the controlling account with the sum of the subsidiary account balances; the discrepancy had existed for three years.)	476.00
3. Flood damage (This represents an uninsured loss from damage to factory machinery caused by a river flood in March 1952.)	4,765.00
4. Bond discount (This represents the discount on $200,000 of 3%, twenty-year, first-mortgage bonds, sold January 2, 1951.)	5,000.00
5. Organization expense (This represents legal fees incurred when capital stock of no-par value was issued to replace the outstanding par-value stock in 1952.)	800.00

(AIA adapted) [1]

Problem 1–8. The Retail Hardware Corporation purchased on December 31, 1950, a cash register for $1,500, paying $500 down and giving a series of notes of $100 each, payable on December 31 of the ten following years. In your audit for the year 1954 you find this item stated in the "Cash Register" account and on the balance sheet at $900. The bookkeeper explains that the corporation does not consider the register as its property until all the installment notes have been paid, although the bill of sale passes title unconditionally. (*a*) State what entries should be made to show the facts (assume depreciation at 6%). (*b*) How will they be shown on the balance sheet? (*c*) What explanation will you give the bookkeeper in support of your instructions? (AIA adapted)

Problem 1–9. On February 10, 1953, an error of $4,500 in the December 31, 1952, inventory was discovered when it was found that one section of the inventory listing had been misplaced and never included in the inventory

[1] This and other problems noted AIA are used through the courtesy of the American Institute of Accountants and are taken from the Uniform Certified Public Accountants Examination prepared by the Board of Examiners of the American Institute of Accountants.

summary. The controller recommended that no entry be made at the time the error was discovered as "it affects last year only." In your examination for the year 1953, this inventory error and the controller's decision are brought to your attention. Would you recommend any adjusting entry at that time? Why or why not? If you do recommend adjustment, prepare the entry you think would be necessary.

Chapter 2

EVIDENCE IN AUDITING

The necessity for verification of accounting data is discussed at some length in Chapter 1. Granted, then, that accounting data may contain errors of various kinds, what does an auditor do about it? How does he go about locating such errors and correcting them?

Before such questions as these may be answered, the position of an auditor in facing his verification problem must be understood. In commencing an examination of the accounts of a company, an auditor rarely knows at the outset whether errors have or have not been made. He has at the beginning little or no indication of whether or not the accounting data are correct or are unreliable. His task is, therefore, to determine whether the accounts are correct and if they are not in what specific respects they are in error. This requires that in a systematic and carefully considered manner he must collect sufficient evidence of the accuracy or inaccuracy of the accounting information presented to him to convince himself of its relative accuracy.

As a result of his examination he will be expected to give his professional opinion as to whether all is or is not in order. The independent auditor does this in a formal document called a "certificate" or "auditor's opinion"; the internal auditor may accomplish the same thing by means of a letter or other report to his superiors. But each of them is expected to state his opinion of the reliability of the information he has examined. Further, he is expected to support his opinion with satisfactory evidence if anyone contests his conclusions.

Thus an audit examination is largely an orderly collection of evidence, evidence that gives the auditor a basis for forming an intelligent decision and for supporting that decision if it should ever be questioned.

Attitude in Collecting Evidence. In collecting and evaluating his evidence it is imperative that the auditor maintain the proper frame of mind or attitude toward the information he obtains. The most essential feature of his attitude here is one of impersonal independence. He is a searcher after facts, a research worker as much as any technician in a laboratory. He must refrain from coming to hasty conclusions and

must not permit personal relations with members of the company's staff to interfere with his detached and realistic appraisal of the situation.

He is not a supervisor of those members of the company's accounting department with whom he works, nor is his aim to point out their mistakes with a "you can't get away with that" attitude. He is their fellow worker in striving to obtain the best accounting data possible. The auditor and the accounting department work by different means and with different techniques, but both should be interested in the same end result—accurate and reliable financial data.

Above all, the auditor must remember that he has an obligation to those who rely upon his expressed opinion. They will count on him to be fair and impartial in his work and in arriving at conclusions. This he must be at all costs. An auditor is primarily interested in convincing himself as an independent expert that the financial data submitted for his examination are or are not accurate. If he obtains sufficient factual information to satisfy himself he should have sufficient to satisfy others. Any time that he is in doubt whether his evidence is or is not sufficient he should ask himself whether that same evidence would be sufficient to satisfy someone outside the enterprise who has no acquaintance with any of the personalities involved.

General Procedure of Verification. If verification consists of an orderly and systematic collection of evidence as to the accuracy of the accounting records, it follows that some procedure must be followed (1) which gives reasonable assurance that any errors existent in the data or records will be discovered, and (2) which facilitates development of an orderly program of work. Actually there are two phases to an audit examination, although both go on concurrently and sometimes appear to be indistinguishable. First, there is the verification of the amounts or account balances to be shown in the financial statements or other reports; second, there is the verification of procedural methods to insure that control measures as established are being followed. Of these two, the first, verification of balances, appears to get the most attention and seemingly is the phase around which the audit program of work is organized, although it will be seen that the second phase actually does receive considerable attention as well.

In verifying balances, the logical and generally accepted plan of attack is to begin with the end result, the account balance, and then work back to the source of the entries to prove that all debits and credits to the account are the result of legitimate transactions properly analyzed and recorded. Once this is accomplished there remains only the neces-

sity of proving the arithmetical accuracy of the account balance and of reviewing the appropriateness of the description given to the account balance before considering the account verification completed. Needless to say the actual verification is not as simple as that; it includes a good many specialized steps and frequently meets with serious problems. Basically, however, the procedure is to work backward from the account balance to the details which have given rise to that balance and then to prove the existence and appropriate entry of those transactions.

It should be recognized that this is the opposite procedure to that followed in general accounting or bookkeeping. In accounting we are concerned with taking a great mass of transaction data, analyzing it, recording it in accounts, and summarizing the accounts into single amounts (balances) for presentation in statements and reports. Accounting is largely constructive; it seeks to build understandable reports out of a great mass of unorganized data. Auditing, on the other hand, is primarily analytical. Auditing takes the end product of accounting and then asks the question: "How can we satisfy ourselves that this report, this summarized information, is accurate?" The answer is apparent. We must get back to the transactions upon which this summarized information is based. Verification, then, consists of working backward through the accounts and records of the accounting system in search of such evidence as will enable the auditor to decide whether or not the account balance is correct.

This requires an entirely different point of view than does accounting. In accounting we are constantly striving to learn and follow the best accounting methods and theory. In auditing we are trying to unravel the procedures followed by others. They may not be aware of the best methods and theory. They may have peculiar little tricks and devices they have worked out themselves to give them the information they feel is helpful. Sometimes these specialized methods may be entirely satisfactory; at other times they may be misleading or even completely erroneous. An auditor is faced with the necessity of working with records as he finds them, not as he would like to have them. He is presented the results of someone's work and must find out whether that work has been satisfactory. This is a far different matter from that of beginning with the original transactions and working toward a goal of adequate and accurate reports.

There are a tremendous variety of possible ways of keeping accounts, and an auditor must learn to be adaptable enough to work with any he finds and to judge its results fairly and impersonally whether he likes the particular method or not. The accounting for accounts payable may be

taken as an example. The voucher system is one way of handling accounts payable, and if performed properly the steps in the vouchering procedure give excellent control over the amounts owed to creditors and payments of such amounts. But a great many companies do not use the voucher system. Some of them use a straight accounts payable ledger system similar to the accounts receivable ledger system with which we are familiar. Others have neither vouchers nor a ledger; they record invoices from suppliers, not when received, but only when paid; thus they have no accounts payable on their books. To arrive at the amount of accounts payable at the end of each month to be recorded in their monthly financial statements, they prepare a work sheet listing all the unpaid invoices they have received and then record the totals of that work sheet by journal entry so that over the end of the month they do have a record of the accounts payable at that date. Promptly at the beginning of the next month they reverse the entry and follow their customary practice of recording invoices only as paid. Still others use modifications of one or another of these three basic methods so that in practice there is a considerable variety of methods in use.

An auditor must be prepared to take any one of these various methods and determine whether the accounts payable amount arrived at is correct and, further, whether the procedure followed gives the company satisfactory control over payments on account. If he were the accountant in the given case he might be able to select his own preferred method. Because he is an auditor and is working after the records have already been made, he must take what he finds and then attempt to satisfy himself as to the accuracy and reliability of its results.

The two words "constructive" for accounting and "analytical" for auditing are very helpful in summarizing the difference between the two fields. An accountant constructs by taking the information in sales tickets, purchase invoices, checks, and other such documents and working through the books of original entry and ledgers to financial statements. An auditor analyzes by commencing with the amounts the accountant has presented in his financial statements and working back through the accounts and books of original entry to the sales tickets, checks, and invoices which are the basic evidence of the amounts in the statements.

An auditor also examines the manner in which established procedures have been followed. Here again he is not following the procedure; he is determining the extent to which others have followed it. Thus it is a matter of tracing the work of others and determining from their results the extent to which they have acted properly. The expression "review"

is used frequently to indicate this procedure of operating after the original work has been done; an auditor reviews purchase invoices, for example, to ascertain if all the required steps of checking extensions, footings, and discounts, of verifying quantities with receiving reports, and of comparing with purchase orders for description of the merchandise and pricing, have been complied with. He determines this by looking for the initials of the individual authorized to approve each of these facts, and if no such initials appear or if the initials of another person appear he knows that an error in procedure has been made.

One of the most difficult adjustments for most beginning students in auditing is to make this transition from the constructive attitude of accounting to the analytical attitude of auditing. Unless such an adjustment is made, however, success as an auditor is well-nigh impossible.

Nature of Evidence in Auditing. Evidence in auditing is any document, procedure, or piece of information which assists an auditor in forming his professional opinion as to the accuracy of the financial information he examines. Obviously there are various grades of evidence; some information is more convincing than other. For example, in verifying the balance of the Petty Cash account as of a certain date the auditor may be shown the required amount in coin and currency. This is convincing evidence indeed. In verifying the balance of an account like Income from Sales of Scrap, he may find that credits to that account are entirely unsupported by documentary evidence of any kind. A credit of $25, for example, may be explained by the employee concerned as being an amount received from a passing scrap dealer for an accumulation of scrap metal from the manufacturing process of the company. This, of course, is not completely satisfactory evidence. The auditor can trace the $25 item into cash receipts and make sure that at least that amount was received and properly accounted for, but he has no assurance that a larger amount was not received and some of it intercepted by the employee receiving it.

This simple example points out the necessity for an auditor to be constantly alert to the validity of the evidence he can obtain. If evidence presented is not in itself satisfactory, then additional proof must be obtained. Sometimes this is possible, and sometimes it is extremely difficult. There may be, for example, no way in which the actual amount of the scrap sale in the example above can be determined. On the other hand, the name and address of the dealer may be available and, assuming the dealer has adequate records, the amount can be ascertained by corresponding with him.

The problem of determining what is acceptable evidence and what is not in any specific case is left squarely up to the auditor. One of the marks of a profession is the necessity for the exercise of judgment by the members of the profession in their work and then acceptance of the results of their choice. As one gains experience in any field, his ability to judge wisely should increase. Even in an elementary course such as this there are opportunities for practicing the exercise of judgment, especially in evaluating the relative strength of different types of evidence.

Types of Evidence. Inasmuch as an audit examination is a process of accumulating evidence, some attention should be given to the various types of evidence which can be collected. It will be apparent that the types of evidence to be described in this section will tie in rather closely with the basic auditing techniques to be described in Chapter 3. The emphasis in that chapter is on the procedure of collecting the evidence, the technique which obtains the proof of accuracy or inaccuracy. In this section the intent is merely to point out the types and likewise the varying grades of evidence which can be collected by the techniques to be discussed later.

For purposes of general discussion, nine different types of evidence can be listed. These are:

1. Physical examination by the auditor of the existence of the thing represented by the accounts.
2. Authoritative documents prepared outside the enterprise under examination or within the enterprise.
3. Oral or written statements by independent third parties.
4. Calculations by the auditor.
5. Satisfactory internal control.
6. Complete subsidiary or detail records in good order.
7. Subsequent actions of the company under examination.
8. Formal statements by company's officers or employees.
9. Informal statements by company's officers or employees.

Each of these may require some further explanation.

Physical Existence. Among the strongest evidence available to auditors is the actual existence of whatever the account balance is supposed to represent. As mentioned previously, the existence of the required amount of coin or currency is good evidence of the claim in the balance sheet that the company has a petty cash fund of a given amount. If the auditor can actually see the asset claimed to exist, he can be con-

vinced of its existence. But it should be noted that there is a weakness even in this evidence. Existence does not necessarily prove ownership. A company may have machinery on lease or other rental arrangement. The existence of such equipment in itself would not support such an asset as a balance sheet item of the leasee. So there are times when physical existence alone is not satisfactory evidence but must be accompanied by some additional evidence of ownership.

It is also apparent that this particular type of evidence is not applicable to all accounting data. Accounts payable, for example, probably have no physical existence. Only those items which are tangible can be supported by such evidence.

Authoritative Documents. Documentary evidence is probably relied upon by auditors more than any other single type. Included are purchase invoices, canceled checks, sales tickets, petty cash vouchers, receiving reports, contracts, official minutes of the board of directors, bond indentures, insurance policies, and many others. This variety of business papers can be divided into three groups from the standpoint of adequacy of evidence:

(*a*) Those prepared outside the enterprise under examination.
(*b*) Those prepared inside the enterprise but validated by independent sources.
(*c*) Those prepared and used completely within the enterprise.

Purchase invoices, for example, come from outside the company and therefore, if their authenticity can be established, are quite reliable as evidence of the transaction they purport to represent. Checks are prepared within the enterprise but are sent out for endorsement and processing by banks and clearing house agencies and so become valid evidence Ledger accounts, on the other hand, are prepared entirely within the enterprise and therefore are not as reliable evidence. Rewritten ledger accounts to present a desired set of data are not unknown. Perhaps another group of business papers should be added: those prepared entirely within the enterprise but which also bear the signature of officers or employees other than those preparing the document and therefore are somewhat more reliable as evidence than if they did not bear such signatures.

A petty cash ticket for supper money of an employee working overtime may be offered by the petty cashier in support of a purported disbursement. If that ticket has the signature of the individual who received the money it has some standing as evidence. On the other

hand, if it has only the signature of the petty cash custodian himself, its value as evidence is extremely dubious. Stores requisitions signed by the employee receiving the material as well as by the storekeeper are certainly better evidence than requisitions without signature or signed by only one party.

The difficulty with this type of evidence, of course, lies in discovering the validity of the individual document. Anyone can have business forms printed to order, and likewise anyone can affix more than one signature to a given document. Hence the apparent validity of documentary evidence may be illusory. This requires that an auditor keep himself constantly alert to such possibilities and be on the lookout for any indication that a document is not what it seems to be.

Statements by Third Parties. Another of the strongest types of evidence available to an auditor is a statement by an outside interest as to a fact upon which that party is competent to make a statement. For example, the amount of accounts receivable can be verified by obtaining a statement from the individual debtor that he actually does owe the company and that the amount of his debt is the amount which the company shows in its accounts. Accounts and notes payable, balances on deposit in banks, and amounts due from employees or subsidiary companies likewise can be verified by obtaining a statement from the appropriate person.

But this particular type of evidence can be used to prove more than amounts receivable or owed. A statement from a reputable lawyer as to the ownership of property is often the best possible evidence that the company under examination owns fixed assets. Similarly, a statement from the company's counsel that he knows of no damage suits or other litigation may be considered as reasonable evidence that no contingent liabilities of that particular type exist. Statements from agents and trustees are generally accepted as being adequate evidence of amounts held in trust or for other use.

Care must be exercised in obtaining this type of evidence so that the statement is actually received from the outside party whose word is relied upon, but this matter will be given attention in Chapter 3 when the technique of obtaining such evidence is considered at length.

Calculations by the Auditor. The preceding chapter pointed out the many possibilities for error which lie in the arithmetical calculations essential to accounting and bookkeeping. To prove the accuracy of such calculations requires their recalculation by the auditor. There is no

more simple type of evidence acquired by an auditor than his own verification of a column total, for example, by adding the amounts in the column. To become useful evidence, of course, the fact of the recomputation must be recorded so that the auditor can refer to it as occasion may warrant. The general subject of retaining or accumulating evidence will be considered in a later chapter under the subject of work paper procedures.

Satisfactory Internal Control. A soundly conceived and efficiently operating system of internal control offers reasonable assurance that errors will either be prevented or will be discovered readily in the ordinary course of routine operations so that they may be corrected. Thus when an auditor finds that a satisfactory system of internal control is actually in operation he has some evidence that the data produced under that system are reliable. It might be noted at this point that the system must be actually functioning. Many companies have devised elaborate systems of internal control written up in accounting procedure manuals which never really get into practice. Frequently the employees who do the actual work find it desirable, from their own point of view, to take short cuts or otherwise circumvent the "red tape" which constitutes the controls established by the management. Thus an auditor must not only find out what the internal control plan is designed to be; he must also find out whether it is or is not functioning as planned. And, of course, he must also evaluate the controls to determine whether they are satisfactory in view of the circumstances.

Subsidiary or Detail Records. The existence of a set of subsidiary or supporting records in good order is seldom conclusive proof that the data supported by those records are completely reliable. Yet, there is more reason to rely on data supported in this way than to rely on completely unsupported information. The fact that a set of subsidiary records has been kept generally implies that more than one person has been involved in the record keeping. Further, when two sets of records work out to the same result there is some evidence that the result is more likely to be correct than if only one record produced it. It is apparent that this particular type of evidence is neither as dependable nor as strong as some of the types discussed previously, but the existence of subsidiary records in good order does supply a certain amount of reliability. The meaning of "in good order" has some importance. The subsidiary records should look like records kept accurately and currently and maintained in the ordinary course of the accounting work.

They must not, of course, appear to have been prepared especially to impress the auditor. Thus a complete set of detailed records prepared in one individual's handwriting apparently at one sitting rather than being evidence of reliability is more likely to be considered grounds for real suspicion.

Subsequent Actions of the Company. The actual audit work is commonly undertaken some time after the close of the period under examination. Thus it is possible for the auditor to appraise statements of fact made by the company in the light of subsequent events. For example, if the company states that a certain liability is $500 on June 30 and then later mails a check to the creditor for that amount, there is some evidence that $500 was the actual amount of liability. An auditor makes as much use as he possibly can of the advantage he has in working on a concern's books and records some time after the end of the period he is examining. He has the benefit of hindsight and it often gives him information or evidence he can rely on with little fear of going astray.

Formal Statements by Company Officers and Employees. The position of those who actually keep the accounts and records or who control the keeping of them is such that if they willfully desire to conceal information from an auditor he can often discover that fact only by undertaking tests and following procedures so detailed and extensive as to be prohibitively costly. Thus, it is not unusual for an auditor to rely to a limited extent on statements made by those on the company's staff qualified to make such statements.

An auditor finds it necessary to ask a great many questions during the course of an audit examination. Some of them are of such importance that he feels he would like to have the answer to his question in writing, so he requests the individual concerned to state it in the form of a letter. As an example, an auditor in reviewing the minutes of the board of directors' meetings may have no way of knowing that all minutes have been made available to him. That is, his only record of meetings consists of the minutes which have been given to him. If there are other meetings for which minutes have not been supplied to him he is completely in the dark. In order to have reasonable assurance that all meetings have been adequately covered by his study he may request the secretary of the company to give him a statement listing the dates of all board meetings. With this as a guide he can determine whether all meetings are accounted for by a set of minutes.

Such evidence of course is not as sound as that which has been obtained from an outside source because it is received from someone who might have an interest in leading the auditor away from the truth of the situation. Yet in the circumstances it may be the best information available and quite satisfactory.

Informal Statements. In addition to the formal statements which an auditor obtains, he will also get answers to a great many questions asked in a conversational way during the course of a day's work. There is nothing in such questioning which smacks of a cross examination or anything of that sort. Peculiar entries, the location of certain documents, a person's reasons for handling a certain item in a given way, and a great many other matters must be inquired about on every audit examination. The answers which are given of course constitute evidence. Again, it is not the strongest evidence and must be weighed with that thought in mind. If such answers can be tested with other information, can be verified some other way by obtaining one of the other types of evidence discussed, so much the better. But again this kind of evidence is a start toward getting the information the auditor must have. Sometimes it is the only information available; in other cases it may be entirely satisfactory although other evidence could be obtained if necessary.

Evaluation of Types of Evidence. From this brief description of the various types of evidence which an auditor may be able to obtain and on which he depends for the forming of his professional opinion, it is apparent that there is considerable variation in the validity or strength of one type as compared with another. For example, one would rather rely on the signed statement of an outsider than to trust a casual answer received from a member of the accounting department. Likewise, a count of the cash in a cash fund is better evidence than would be a statement from the petty cash custodian to the effect that he had the desired sum on hand. An auditor must always have in mind the relative strength of the different types of evidence and attempt to get the best evidence in the circumstances. This does not always mean the strongest evidence available.

An auditor's problem is to get the best evidence available in view of the circumstances. Two factors may deter him from holding out for the very best evidence in every case. The first of these is materiality. The relative importance of an item is always a controlling factor when an auditor selects the particular method he will apply and the evidence he will accept. Note that it is a matter of relative importance. Relative

means that other information of that particular set of circumstances must be considered. What is of great significance in a small concern may be immaterial in a large company. Likewise, what is important in one case may be of little consequence in another. But importance does not mean size alone. A five-dollar error might be of no consequence whatsoever unless it hinted that perhaps fraud was present. Then it would be of considerable importance and would require investigation until the auditor was completely satisfied one way or the other.

Of what importance is materiality in the evaluation of audit evidence? Obviously the less valid types of evidence may be accepted for immaterial items far more readily than for important items. Again a simple example might help. In examining the accounts of a large company it might be entirely satisfactory to accept the statement of a petty cash custodian at an outlying branch office that he had a sum of $100 on hand, whereas no such statement could be accepted from the general cashier who was in charge of currency amounting to several thousand dollars. The more material the amount or the item involved, the stronger must the evidence be to satisfy an auditor.

The other factor of considerable importance is one of relative cost. In business, cost is always a matter of importance. An auditor must concern himself with the cost of his procedures in the same way that a merchandising man concerns himself with the cost of the products he offers for sale. This is not to say that cost is the first or the only consideration. But, in determining whether a given type of evidence is satisfactory, or whether more or different evidence must be added, the problem of relative cost is always to be considered. Rarely is an auditor, or anyone else in business for that matter, in a position where money is no object. The cost in effort must always be weighed against the results. If an item to be verified is immaterial, the effort to be expended on it will be slight. If an item is of real significance, the cost of verification can be and generally will be considerably higher.

With these factors, materiality and cost, in mind, an auditor proceeds to collect the kind of evidence he feels necessary to convince himself that the facts are as stated or that they differ from the records and in what way. Not until he is convinced one way or the other is he in a position to give his opinion.

Quite obviously being convinced does not mean being sure beyond the shadow of a doubt. Accounting data are of such a nature that one can rarely be completely sure about the propriety of highly summarized facts in financial statements. Every auditor every time he offers his opinion takes what may be termed a "calculated risk." He is reason-

ably certain of the reliability of the data and therefore is willing to risk his professional reputation by stating that he considers the information reliable. Needless to say, the more he can minimize the risk, the more freely he gives his opinion.

"Common Law" of Evidence in Auditing. Auditing is a relatively young profession, and very few of its practices or theories have been codified into anything having even a semblance of legal force. And yet there are certain practices which are generally accepted and generally followed that to all intents and purposes do govern the performance of audit examinations in the same way that legal rules govern business transactions. Considerable disagreement might exist on a complete list of such practices, but the following four would probably receive general acceptance as at least a beginning:

1. The evidence relied on must be adequate to satisfy a reasonably competent auditor.
2. Conclusions may be based on tests and samples of the data under examination.
3. The size of tests and samples may vary with the extent and effectiveness of the internal control.
4. Pertinent information disclosed after the close of the period under examination may and should be taken into consideration in evaluating the data as of the end of the audit period.

Of these four, the first one has had considerable attention in preceding paragraphs; the others may require some further brief comment.

Conclusions May Be Based on Tests and Samples. It should be apparent that an audit crew cannot begin to repeat every action of an accounting department in order to insure that no serious errors have been made. To do so would make the cost of auditing prohibitively high. Instead of attempting to repeat the accounting work, auditors will select a certain proportion of the data; and if no errors are found it may be presumed that the rest of the data likewise contain no errors. This particular practice is virtually a necessity, but, more than that, it has over many years been found to be entirely satisfactory. If the tests and samples are selected with care and with full consideration of the surrounding circumstances, they are frequently every bit as effective as if a great deal more work had been done.

Reliance upon tests requires, first of all, that the extent of the test be considered as confidential information by the audit staff. If the com-

pany's employees know that the auditor does only two months' testing of cash book footings and if they can also detect from various indications of the auditors' work a pattern in the selection of months tested year after year, they are in position to commit any intentional errors they have in mind in such a way that the errors are much less likely to be discovered. For that reason it is generally considered to be sound audit practice to keep the extent of the test and the exact periods tested confidential, and further to refrain in so far as possible from leaving any identifying tick marks or other indication of the extent of the tests in the client's records.

Another requirement in the reliance upon tests is that any item arousing suspicion in the performance of the test must be thoroughly investigated. Because he does rely upon tests, an auditor has something less in the way of opportunity of discovering errors. Hence, any errors he does find, or rather any apparent errors, must be fully explored. Alertness and thoroughness in the application of tests is essential.

Variation of the Extent of Tests in Conformity with the Effectiveness of the Internal Control. The factor upon which the auditor relies most strongly in determining the extent of his tests and samples is the degree of internal control effective in the company's accounting system. If the company under examination has a weak system of internal control in regard to payroll procedures, then the verification of payrolls must be expanded well beyond what it would otherwise be. On the other hand, if a concern has an extremely effective program for approving invoices and making cash disbursements, the auditor can reduce his tests in that area to the minimum.

The coordination of the audit program with the client's system of internal control is indeed one of the fine arts of auditing practice. A sound understanding of accounting procedures, of errors, and of audit techniques, together with good judgment and experience in the field are all essentials if a high standard of performance is to be attained.

Information Disclosed after the Audit Date. As mentioned earlier, an auditor must make full use of any significant discoveries after the audit date. Only by so doing can he be confident that he has not missed important developments which do affect the financial statements he is to examine. For example, the settlement of a lawsuit after the close of the fiscal year may point out the need for including a statement in the balance sheet as of the close of the year to the effect that the company has a large contingent liability at that time. The classic example of the

use of this type of information is that of the auditor who saw no need for comment on a December 31 balance sheet of the fact that the company's properties had been completely destroyed by fire on the following January 20. Although he did not complete his examination and give his opinion until after January 20, he reasoned that as of December 31st there was no knowledge of the fire and therefore no need to comment on it. To obtain the proper perspective on such a matter he had only to put himself in the position of an innocent third party reading that balance sheet on January 25. Should such a person be given some warning of the event which destroyed the concern's operating potential or should he be kept in complete ignorance? The need for full disclosure is obvious.

Difficulties in Obtaining Evidence. Before leaving the subject of evidence to take up a study of the various audit techniques used to accumulate evidence, it may be helpful to point out some of the difficulties frequently met in attempting to obtain the evidence an auditor needs to permit him to form an opinion. These require little more than mere listing because most of them are quite self-explanatory. Their importance, however, should not be overlooked.

1. Inadequate information because of a lack of records or poorly kept records is one of the most frustrating problems an auditor can meet in his attempts at verification. Happily, the advent of federal and state income tax laws and a more widespread appreciation of the usefulness of accounting data to management have served to stimulate interest in accounting and the growth of satisfactory record-keeping procedures. However, the problem of insufficient or inadequate records is not yet completely done away with, and one must learn to be resourceful indeed in making the most of the information that is available. One must recognize also that in certain situations the lack of information is such that the auditor is unable to form an intelligent opinion and is consequently unable to give one.

2. Sheer mass of detail often makes verification extremely difficult. The verification of a tremendous inventory such as might be found in the warehouse of a large mail-order concern may be extremely difficult merely because of the number of items involved. Accurate verification of cash and securities becomes more difficult as the quantity increases, and the verification of fixed properties in a tremendous manufacturing concern is a real problem. It is in connection with such massive jobs of verification that the appropriate selection of tests becomes extremely important.

3. Lack of cooperation on the part of those who keep the accounting records under examination makes verification difficult and sometimes almost impossible. In most cases cooperation can be obtained if the auditor is willing to take some pains to be pleasant and courteous, and if he will avoid any appearance of being overbearing. In some few cases, however, one meets with individuals who absolutely refuse to cooperate and then one has a most trying time in forcing himself to stay with his verification problem until it is solved.

4. Deliberate concealment or falsification of records makes verification of the accuracy of information difficult but seldom impossible. One of an auditor's problems is to find out what errors are present; whether errors are deliberate or unintentional, if they are present they are possible of location. It should be pointed out, however, that, where collusion is present, that is, where two or more people collaborate in commission of the errors and in their concealment, the probability of discovering them through ordinary audit procedures is reduced. To adopt as standard audit procedure the extensive tests necessary to discover collusion would be to make auditing examinations very expensive indeed. Hence most audit practices are not aimed at discovering all errors resulting from the presence of collusion. If there is reason to suspect such collusion or if it is known to exist, then, of course, the audit work should be expanded accordingly.

5. Difficult accounting problems in some types of business make verification more difficult. Where a company has a complicated assembly problem, the verification of work-in-process inventory may tax an auditor's abilities to the limit. Verification of cash on hand for a company with many branches and a considerable number of cash transfers between branches near the close of the period may likewise be difficult. But rarely is the inexperienced auditor assigned to the more difficult tasks. In most cases he grows into them gradually and finds himself quite well prepared for any new problems by the time they are given him.

6. Peculiar accounting and business procedures followed in certain cases often make work not only difficult but interesting. There is a great deal of improvisation by accountants. Few of them have had formal training to equip them for every problem which comes along. Hence as they meet with new problems in their daily account keeping they must devise methods of recording and controlling the new transactions or new data. Sometimes the methods devised work reasonably well; sometimes they are hopelessly inadequate. An auditor must take such improvised methods as he finds them, attempt to understand what

has taken place, and then determine whether the results portray the events with reasonable accuracy. Meeting with such a variety of strange and unusual practices is one of the features of auditing that gives experience in this field its great educational value.

7. Cost as a problem of obtaining evidence has already been mentioned but perhaps deserves at least passing attention at this point. Cost and materiality are always problems in determining the extent of verification to be followed. Frequently, when the desired evidence might be found by expanding the work, the additional cost of such expansion is so great as to deter one from attempting it.

PROBLEMS—CHAPTER 2

Problem 2–1. State what you consider to be satisfactory evidence to support each of the following:

1. An assertion by the petty cash custodian that he is authorized to cash personal checks for employees out of his petty cash fund.
2. Debits to the Machinery account.
3. The balance of the Investments account.
4. The list of outstanding checks in the bank reconciliation.
5. Debits to Salesmen's Commissions account.
6. The balance of the Prepaid Insurance account.
7. The balance of the Notes Payable account.
8. The amount of income from sales of scrap.
9. The quantity of coal in a huge pile near the power plant.
10. The balance of the Miscellaneous Expense account.

Problem 2–2. The Good-as-Gold Finance Company makes small loans to individuals on notes secured by chattel mortgages or by wage assignments, and also discounts notes receivable taken by local used car dealers on car sales. The principal asset of the company consists of the notes receivable. What various types of evidence would you expect to accumulate in support of the balance of the Notes Receivable account?

Problem 2–3. The Moyer Manufacturing Company constructs much of its own equipment. In accounting for construction jobs in process, a work order or job sheet is established for each project. To the work order are posted all costs accumulated during construction. Work orders for jobs not yet completed make up a subsidiary ledger controlled by the Construction Work in Progress account in the general ledger. What types of documentary evidence would you expect to examine in verifying the balance of the Construction Work in Progress account? What other types of evidence might be required as well?

Problem 2–4. List all the types of evidence that might be necessary to support the inventory figure in the balance sheet of a department store.

Problem 2–5. Give the type or types of evidence you feel would be satisfactory for each of the following:

1. Merchandise inventory out on consignment.
2. An advance to a subsidiary company.
3. A note payable to the president of the company.
4. Securities owned by the company but deposited with a bank as security for a note payable.

5. C.O.D. shipments in transit.
6. A good faith deposit required with a bid for a public housing construction contract.
7. Royalty payments made during the year under patent rights.
8. Merchandise inventory stored in a public warehouse composing 80% of the company's total inventory.
9. An inventory of patent medicine based on a secret formula.
10. Timber resources of a lumber company.
11. The inventory of containers for a "bottled gas" distributing company.

Problem 2–6. The Farm Mortgage Realty Company makes a practice of buying up mortgages on farm lands. Whenever a mortgagee is unable to pay off his obligation the Realty Corporation forecloses on the property. It then holds the property until such time as sale appears profitable. An account in its ledger entitled Mortgage Notes and another called Farm Lands are used to record the principal assets of the company. What evidence would you obtain in support of the balance of each of these accounts?

Problem 2–7. (*a*) Is an auditor interested in checking transactions occurring between the date of the balance sheet and the close of his examination? (*b*) If so, give certain specific examples of auditing steps which might be taken and the reasons therefor. (*c*) State what effect matters disclosed by this additional auditing might have on the statements submitted. (AIA)

Problem 2–8. What evidence would you accept as satisfactory documentary evidence, such as sales invoices, vendors' invoices, or other original records, in support of entries in the following: (*a*) sales register; (*b*) sales returns register; (*c*) creditors' voucher or invoice register; (*d*) payroll; (*e*) check register. (AIA)

Problem 2–9. State what documents or evidence the auditor would examine in the verification of each of the following: (*a*) advertising expense, where advertising is placed through an agency; (*b*) advertising expense, where advertising is placed direct by your client in newspapers; (*c*) royalty expense; (*d*) repair expense. (AIA)

Chapter 3

BASIC AUDIT TECHNIQUES

There is nothing at all mysterious or miraculous about the performance of an audit. Those who believe that an auditor has developed a sixth sense of some kind which enables him to "smell" out errors in the records have little understanding of the real nature of an audit examination. An audit is similar to any other research project; it consists of the gathering of a considerable amount of information and then of evaluating that information fairly and impersonally. Of course, this must be done with skill and care. Planning an effective audit program in an especially difficult situation calls for considerable experience, knowledge, and judgment. Nevertheless, the methods followed in collecting and evaluating the evidence upon which the auditor bases his opinion are very ordinary, relatively simple methods. As simple as they are, however, if properly applied they are extremely effective in locating any weak spots or inaccuracies in the data examined.

The expression "audit techniques" may be used to describe the basic methods of collecting evidence used by auditors. These basic methods are relatively few in number, and it should be noted that they are all directed at supplying the auditor with one or more of the types of evidence discussed in Chapter 2. The technique in itself is not evidence; it supplies the evidence required by the auditor to inform him sufficiently on the subject so that he can give a professional opinion.

Nine basic techniques or methods of securing information may be listed:

1. Physical examination and/or count.
2. Confirmation.
3. Examination of original documents and comparison with the record.
4. Recomputation.
5. Retracing bookkeeping procedures.
6. Scanning.
7. Inquiry.

8. Examination of subsidiary records.
9. Correlation with related information.

The nature of some of these techniques has been suggested by the previous discussion of evidence; yet it may be worth while to give each of them additional attention in order to point out any special features or precautionary measures to be followed in applying the specific technique.

Physical Examination. The basic idea of physical examination is simple. The auditor examines the particular thing to assure himself of its existence. Examination gives him what might be called "eye-witness" evidence. But involved within this idea of physical examination are various subsidiary ideas which require attention.

Physical examination requires, first of all, identification of the item being examined. It does little good, for example, to examine an inventory of purchased parts unless one can tell with reasonable accuracy what is being examined and can later relate it to the information in the accounting records. More than a hazy impression that something exists is implied by the procedure of examination. One must be convinced that he has examined the specific thing which he is supposed to be verifying.

Further, there is in the idea of identification an implication that the auditor is able to distinguish the quality of whatever he is examining. As will be seen when the subject of inventory verification is taken up in detail in Chapter 10, quality is one of the most difficult matters with which an auditor has to deal. Yet if one is verifying top-grade material by physical examination there is certainly an implication that he can identify top-grade quality with some reasonable degree of accuracy and that he is alert to the possibility of other than top grade being present.

Genuineness of the thing examined is also implied. Verification of cash by actual count implies that the auditor will recognize lead nickels, for example. He may be unable to spot a carefully forged ten-dollar bill which would pass anyone except an expert in the detection of fraudulent currency, and yet, unless he can be counted on to recognize at least the most obvious attempts at substitution of imitations for the real thing, his physical examination is of little value as a verification technique.

Physical examination also suggests that quantity will be given consideration. One who is supposed to verify the existence of three delivery trucks by examination should not be content if he is shown but two. Count is such an obvious part of physical examination that it should be included almost without separate mention.

Thus physical examination implies count, identification, and, to at least a limited degree, verification of genuineness and quality. No limits have ever been established for the auditor's responsibility in regard to quality and genuineness, but it should be obvious that he has the responsibility of any reasonable business man to recognize the obviously false or unsatisfactory quality. He cannot be expected to be an expert in every type of material or other asset he will be called on to verify by this means. On the other hand, he cannot dodge responsibility by merely stating that he is not an expert. To do this would be to admit that this technique was actually not worth the cost of performance. Somewhere in between these two extremes lies the real solution. Probably it cannot be described any more clearly than to say that the auditor has the responsibility of a reasonably alert and intelligent professional man to discover any lack of authenticity or any discrepancy in quality.

As discussed in Chapter 2, physical examination does not of itself prove title to the thing examined. Hence additional consideration must be given to establishing the fact of ownership.

The applicability of this particular technique is restricted to those assets which are either material or have some tangible evidence of existence. It is extremely useful in regard to cash, inventories, fixed property additions, and the like. Auditors generally consider that they verify such assets as notes receivable, stocks and bonds, and similar properties by inspection also. Whether there is a technical difference between examining the thing that is a unit of product in inventory and the certificate that represents a share of stock is of small consequence at this point. Physical examination can be applied to both types of assets.

Confirmation. As a verification technique, confirmation consists of obtaining a written statement from someone outside the enterprise on a fact which that person is qualified to affirm. Properly applied, it is one of the most useful techniques available to an auditor and supplies evidence of considerable reliability. It can be used to verify such various facts as the amounts owed to the company under examination by the various customers of that company, amounts owed by the company, amounts on deposit in banks, the existence of litigation or other contingent liabilities, the existence of inventory stored in a public warehouse, and title to property.

The requirements for confirmation are, first, that a reliable independent party be informed on the matter of interest to the auditor, and, second, that the statement of the informed party be obtained directly by the accountant with no possibility for influence or change by the company

under examination or any of its employees. This introduces the problem of maintaining control over confirmations, an absolute necessity if the evidence produced by this particular technique is to be of any value whatsoever.

Preliminary to discussing control, however, it is necessary to understand the situation in which an auditor finds himself. If we take the problem of verifying accounts receivable by confirmation the problem becomes apparent. The customers of a company, if they have an account with that company, are indebted to it and should be willing to acknowledge that indebtedness. This is not to say, however, that they will make such acknowledgment to anyone who asks them. If the auditor were to write to each of them in his own name asking for certain information as to the amount those individuals owed a given company, it is a fair assumption that most of them would refuse to answer. An auditor has absolutely no legal or other standing which permits him to pry into the financial affairs of others. Indeed, to do so might cause the company he is examining to lose goodwill with its customers.

Thus, as a matter of courtesy to the customer, the request for information should come not from the auditor but from the company. If a company asks its customers to acknowledge their obligation to it they are far more likely to cooperate than if some unknown party, whether he is an auditor or not, makes the request.

Along with this practical necessity of having the request come from the company rather than from the auditor is the other necessity of insuring that the answer to all requests for such information be sent directly to the auditor without any opportunity for the company staff to interfere in any way. This makes necessary the following detailed and yet extremely important control measures on the part of the auditor.

1. After the letter requesting confirmation by the customer has been prepared by the company's staff, it must be returned to the auditor for final approval and mailing. He should examine it to make sure that the details of the customer's name and address and the amount agree with the accounts receivable record to be verified.

2. The confirmation request should be inserted in the envelope by the auditor and the envelope deposited by him in an official receptacle of the Post Office Department.

3. The envelope in which the request is mailed should bear the corner card or return address of the auditor so that if it is not delivered for any reason it will be returned to the auditor and he can investigate the reason. If the company's corner card is on the envelope the auditor may never learn that an undeliverable confirmation request was mailed.

4. A stamped envelope addressed to the auditor at his own business address should be included with the confirmation request to insure that the answer is sent directly to him and is not subject to interception and possible change by the company or members of its staff.

The necessity for these procedures should be apparent. Any relaxation of control by the auditor makes it possible for the company or members of its staff to alter confirmation requests before mailing, to fail to mail them, to mail them to incorrect addresses, or to intercept the returning confirmations. If any of these are even possible, the auditor cannot afford to rely on the confirmation and it becomes of no value as evidence.

It might be noted at this time that the use of this technique is so widespread that many auditors have special forms prepared which require only the filling in of a minimum of information and signature by the proper company official before mailing. This facilitates the sending of the requests and also is of help in maintaining control over the confirmation procedure. The detailed steps to be followed in applying the confirmation technique to different aspects or phases of the verification work will vary, of course, but in general the requirements for control are the same in every case.

Examination of Original Documents. In modern business, almost every transaction between two companies or between a company and an individual is evidenced by a document of some kind. Further, many transactions or events within an enterprise are recorded through the preparation of a document which then becomes the basis for recording the transaction. Included in this idea of documentary evidence for transactions are purchase and sales invoices, checks, remittance advices, insurance policies, contracts, stock certificates, guarantees, requisitions, purchase orders, receiving reports, and a host of specialized papers.

Business papers of this type provide the original record of the given transaction and constitute the evidence of that transaction. Auditors therefore rely on such original documents as evidence that a transaction is or is not as indicated by the record. Thus, in verification of items recorded in the purchases record, purchase invoices will be examined and compared with the purchases book; canceled checks will be examined and compared with the check register or cash disbursements book; petty cash tickets will be examined and compared with the record of petty cash disbursements.

What is implied in an examination of original documents and their comparison with the record? First, it is implied that at least reasonable

assurance of the authenticity of the document is obtained. It is not always possible to insure beyond doubt that a piece of paper is what it purports to be, but at least an alert auditor should discover any patently fraudulent documents. Second, the propriety of the transaction as being one appropriate to the particular company should be established. That is, the purchase of personal items for an officer or employee is not a legitimate transaction of the business and should be questioned. Likewise, a transaction of another concern, the document for which was sent to the examinee company in error, should be detected. Third, approval of the transaction as evidenced by appropriate signatures or supporting documents must be ascertained. Fourth, the proper recording of the transaction must be established. That is, the purchase of advertising materials should not be charged to Salesmen's Salaries nor should a repair item be charged to a fixed asset account.

In examining original documents an auditor must be alert to all these possibilities, and when he passes a document as satisfactory evidence of an entry he should be convinced on all of the four points mentioned above.

Recourse to documentary evidence is had in two different ways. First, all entries of a certain type for a given test period may be verified by reference to the appropriate business papers. For example, all the purchase invoices paid the month of December may be examined in support of the cash disbursements for that period. Second, individual transactions or entries in accounts may require substantiation, in which case the auditor calls for the specific documents which evidence those transactions. In verifying an account for Machinery, for example, a substantial addition will require that the auditor examine the invoices for the new equipment and for any installation charges as well as the contract to purchase, any service agreements, and the like. It is imperative that all related documents be examined in order that all facts surrounding the transaction be uncovered. If not, there is a real possibility that the entry may have failed to take into consideration important features or consequences of the transaction. For example, the machine might not have been purchased but merely rented.

In some cases this procedure must be modified to the extent that duplicate rather than unavailable original documents must be examined. This is true of sales invoices. The original sales invoice is customarily mailed to the customer; therefore it is not available for examination by the auditor; hence he must be content with examination of the duplicate. A duplicate is not as satisfactory evidence as an original, but for sales transactions there is no real alternative. However, it does suggest that

supplementary verification may be required. A duplicate sales ticket backed by shipping documents becomes stronger evidence than an unsupported sales ticket, for example.

Recomputation. Recomputation is at once the most simple and the most valid verification technique. It is complete in itself. Once a footing or an extension has been proved by the auditor's own calculation he can accept the arithmetical accuracy of the result without further question. Recomputation is also one of the most widely used techniques as it is necessary at a great variety of points in the accounting process. Footings of books of original entry, ledger account balances, inventory extensions and footings, depreciation and bad debt computations, bonus calculations, write-offs of prepaid insurance and patents, and many other similar simple calculations require verification.

Inexperienced auditors are likely to underestimate the need for this type of verification. Until one becomes accustomed to the idea that any total or the result of any combination of figures may be incorrect, it is difficult to remember that any such result requires verification. Further, the finality of a total on an adding machine tape is very impressive and one may hesitate to incur the startled attention to be received when he re-adds the amounts on such a tape. But anyone who has had experience with an adding machine tape realizes that after the proper amounts have been listed the tape can be rolled ahead so that additional amounts, positive or negative, can be placed in the machine and then the tape rolled back to the place where the correct list of figures ends. Thus, an incorrect total can easily be obtained at the end of a correct series of amounts. The rule "never accept a client's tape" is a very practical one and should never be broken without a recognition of the risk which follows.

Retracing Bookkeeping Procedures. To discover any errors which may have been made in such bookkeeping procedures as posting from books of original entry to the ledger, or in taking trial balances, it is necessary for the auditor to repeat that particular procedure. Thus it is necessary to trace a certain number of postings and to repeat the taking of a trial balance both of the general and the subsidiary ledgers. This procedure is similar to that of recomputation in that it is not difficult to apply and is valid evidence once accomplished.

Scanning. To scan means to scrutinize or to examine point by point. In auditing it refers to the critical study of an account, a book of original

entry, or any other record or summary of information. If there is any technique which approaches the sixth sense sometimes mistakenly attributed to auditors it is that of scanning. An experienced and alert practitioner can frequently look at a given page and almost immediately conclude not only that something is peculiar but also state exactly where the trouble lies. However, there is nothing miraculous about such a diagnosis. The auditor is merely summoning up all his accounting knowledge and experience on that particular type of information to evaluate that which he sees as being either normal and ordinary or as being unusual and therefore subject to suspicion.

What does one watch for in scanning? First, anything at all unusual. Anyone with a knowledge of accounting and the accounting method should recognize certain practices or entries as being somewhat unusual. For example, a general ledger account for cash in most cases will receive one debit a month from the cash receipts book and one credit a month from the cash disbursements record. Thirteen credits in the space of a single year should arouse one's interest as to what the necessity for the thirteenth item might be. In the same way a debit to Cash from some source other than the cash receipts book would bear investigation.

In scanning a journal entry one should question the propriety of that journal entry for the particular concern under examination, the reason for debits and credits of that particular type, and finally the propriety of the entry itself as an application of generally accepted accounting principles. An experienced auditor in scanning a page which included the following entry would immediately have several mental reservations about the propriety of the entry.

Reserve for Bad Debts	$15,000	
Marketable Investments		$15,000

This example is, of course, an extremely obvious one, but it serves to indicate in a general way the sort of thing one is expected to note in scanning.

One must also watch for items which are unusual because of their size. An unusually large or an unusually small item should in most cases be inquired into. In like manner, an amount which does not compare with the same amount for other years or for other months should be investigated. An experienced auditor relies a great deal upon the comparability of data and notes almost without conscious effort any item or amount which is out of proportion to what it should be. And, of course, the unusual item requires additional investigation.

Scanning is perhaps the most indefinite audit technique commonly employed, and it is one which seldom gives rise to easily established evidence. In many cases it merely establishes the necessity for further verification of some other kind. Yet in the hands of an experienced man it is an extremely valuable tool and one never to be overlooked.

Inquiry. Inquiry consists of asking questions and of obtaining satisfactory answers to those questions. The answers range from formal statements in writing to casual conversational comments. Yet by a careful use of the questioning procedure one can learn a great deal about matters which might otherwise be obscure. The answer to a single question is seldom a reliable bit of evidence. The answers to several related questions may provide very satisfactory evidence if they are all reasonable and all consistent.

Foolish questions are of worse than no value. Questions the answers to which cannot be verified or tested in any way are also of dubious value. It is a bad practice to permit those keeping the records to feel that an auditor is willing to rely on their unsupported statements. Once they are sure of that, there is ever less reason for them to give careful, accurate replies to his questions. Occasionally one is forced to obtain additional information by telephoned question, but it should be apparent that such information is rarely subject to real verification. The man who earns himself a reputation as a "telephone auditor" does not have a particularly enviable rating among his fellow practitioners.

Examination of Subsidiary Records. As pointed out in Chapter 2, subsidiary records do constitute some evidence of the authenticity of the data in the records or reports which they support. But there is always the danger that such records may not be authentic themselves, that they may have been hastily put together for the sole purpose of apparently supporting the erroneous data, or that they have been kept in such a careless fashion that neither they nor the data they support are reliable. In examining subsidiary records, then, an auditor must be alert to the possibility of forged records. He must compare the controlling and subsidiary records carefully for any inconsistencies which might indicate a lack of the real relationship which is supposed to be there. When there is any reason to suspect that the subsidiary record is of recent and improper origin he can request evidence of the regular reconciliation with or adjustment to the controlling account at regular intervals in the past.

In most cases this particular technique will be supported by some other verification which will serve to substantiate it. Standing alone, the

evidence produced in this way is scarcely strong enough to support items or amounts of real consequence.

Correlation with Related Information. Within the double entry system of accounting, there is a great tendency for items in one place to relate to those in another. For example, there is generally a relationship between the amount of insurance expense for the year and the decrease in the unexpired insurance account balance. There is a relationship between the increase in the Reserve for Bad Debts and the Bad Debts Expense account. Many similar examples could be pointed out. Auditors are continually on the lookout for possibilities of exploiting such relationships. An asset account which is related to an expense account is not fully verified until that expense account has been reconciled with the asset in some way. The same is true of liability accounts such as Accrued Taxes and Accrued Interest.

The internal harmony or consistency of related accounts is certainly some evidence that those accounts are free of at least mechanical errors, if no others. Another example may help to illustrate the point even further. In verifying the liability account Notes Payable, most auditors will analyze carefully the account for Interest Expense and attempt to relate the total interest expense for the period with the notes known to have been outstanding. Any failure to account for all interest in this way implies the possibility of unrecorded notes payable upon which interest was paid and entered in the Interest Expense account. This requires complete investigation of those interest items not otherwise accounted for. The expression "reconciliation" is frequently used by auditors to describe the process of relating one ledger account balance or other piece of information to another. Thus the Interest Expense account is reconciled to the notes outstanding during the period, and the Insurance Expense is reconciled with the change in the balance of the Prepaid Insurance account.

These nine basic techniques result in the accumulation of the types of evidence described in Chapter 2. As discussed there, some of that evidence is extremely good and some is comparatively weak. Seldom is any single bit of evidence completely convincing in itself. Hence it is necessary to support one type of evidence with another, to bolster a technique of limited usefulness with another until reasonable doubt has been eliminated.

The audit problem is one of evaluating the possibilities for error in the given situation, of determining the types and extent of evidence

necessary to establish the reliability of the data to be examined, and of then selecting the techniques or combinations of techniques which will provide those data most effectively and at the least cost. Drafting an audit program is a matter of tailoring the possible techniques and combinations of techniques to the specific situation. This is discussed at greater length in later chapters.

PROBLEMS—CHAPTER 3

Problem 3–1. Each of the following numbered paragraphs includes an item in a manufacturing business to which verification procedures should be applied and also a single verification procedure. For each item, list at least three possible errors that would not be discovered if only that single procedure were applied.

1. Sales. Compare duplicate sales invoices with entries in sales register.
2. Investments. Examine investments on hand on balance sheet date.
3. Prepaid insurance. Verify calculations of unexpired insurance in insurance register.
4. Additions to Machinery account. Inspect all items of machinery acquired during the year by physical examination.
5. Inventory. Investigate physical existence of all major inventory items.

Problem 3–2. For each basic verification technique, list at least three different applications in what you consider to be an adequate examination of the books and accounts of a medium-sized manufacturing concern.

Problem 3–3. Briefly state the purpose of the examination of accounts payable vouchers and entries thereof in the voucher register. (AIA)

Problem 3–4. In the examination of paid checks returned by the bank to the drawer, state the features of the check to be examined and the recorded data with which the check should be compared. Give a reason for each operation. (AIA)

Problem 3–5. The accountant's short-form report formerly contained the words "supporting evidence." State three different types of such evidence and give several examples of each type. (AIA adapted)

Problem 3–6. During the course of an examination of a corporation you ask the secretary for permission to examine the minute books. He is reluctant to grant your request but offers to give you a certified copy of all resolutions relating to accounting matters. What position would you take, and how would you explain that position to the client? (AIA)

Problem 3–7. State the purpose of the following procedures in an examination of receipts and disbursements.

1. Foot the cash book.
2. Reconcile bank deposits with cash book receipts.
3. Examine paid checks by comparing date, check number, payee, and amount with corresponding data in cash book.

4. Prove agreement between the paid checks and bank withdrawals.

5. Account by check numbers for all checks issued during a period selected for testing. (AIA)

Problem 3–8. Describe the usual documents constituting a voucher authorizing payment of an amount owed for materials purchased by a manufacturing concern. What authorizations and checks would you expect to find on these documents under a proper system of internal audit? (AIA)

Problem 3–9. Name the document or documents, peculiar to each item, which should be inspected by the auditor in the verification of the following. State the particular features to be observed in each case. (*a*) land; (*b*) real estate tax; (*c*) renegotiation settlement; (*d*) rent expense; (*e*) registered stock held by client as collateral. (AIA)

Problem 3–10. The *R* Company operates a retail store in which all sales are made for cash at the time of the sale and recorded on cash registers by the clerks who make the sales. State with reasons what records of cash and sales the *R* Company should keep in order to enable an auditor to make a satisfactory verification of these items in a detailed audit of the company's records. (AIA)

Chapter 4

AUDIT WORK PAPERS

An audit examination, it has been pointed out, is largely a matter of obtaining sufficient information to permit the auditor to form an opinion as to the accuracy and reliability of the accounting data which he examines. As he collects evidence, the auditor must have some means of accumulating it for later study and for reference. Audit work papers are the specific device used to accumulate the evidence needed by an auditor to support his opinion.

Need for Work Papers. The position of an auditor is considerably different from that of a member of the accounting department of a business or other enterprise. The accounting department personnel prepare entries from original documents such as sales tickets, invoices, checks, and contracts. They then have those documents to support and substantiate their entries and the summaries which they prepare from the entries and records. An auditor has no original documents, no books of original entry, no ledger accounts to support his findings. He works with documents and records which he must leave to others when he has completed his examination; thus the only record of his findings and of the work he has performed in arriving at those findings must be prepared by him on the job. If he makes no record he will have no means of supporting his work and the opinion on which his professional reputation depends.

This suggests very strongly that an auditor must be careful during the course of his examination to make sure that he includes in his work papers complete statements of all work done and of the results of that work. A sound practice to follow is contained in the idea that anything worth doing on an audit is worth including in the work papers. That is to say, any work done during the course of an examination should be aimed at accumulating evidence, which, of course, is the general purpose of the examination. If the test or procedure is worth doing, it will add to the overall strength of the examination and should be recorded as a part of the audit work. Likewise, the results of any test

or procedure add to the accumulated information upon which the auditor will base his opinion. It too must be recorded as supporting evidence.

Examples may help to illustrate this point more clearly. During the course of an audit it may be considered desirable to prove the cash receipts book footings for three selected months. When this work is done a record should be made of the fact that the footings of the cash receipts book for those months were tested by recomputation and a further statement made as to whether errors were or were not found. The record of this work and any similar work must be carefully preserved as evidence that the auditor did the work for those specific periods and that the results were as found. Again it is usually considered desirable to reconcile the balance of cash shown in the cash account with the bank statement received from the bank. When this has been accomplished the auditor should keep the reconciliation in his papers as evidence, first, that the reconciliation was performed, and, second, that either all was found in order or that certain adjustments were necessary.

It is generally not difficult to remember to include such audit steps as these in the work papers; other steps are more likely to be overlooked in so far as making a record of them in the work papers is concerned. For example, in verifying the debits to an account for repairs and maintenance, a charge may be discovered which appears as if it might have been debited as properly to a fixed asset as to an expense account. To discover the reason for treatment of the item as an expense, an auditor will inquire of the appropriate person as to why it was entered as it was. He will then evaluate the answer critically and if it seems reasonable will accept the entry as found. However, he must also remember to include in his work papers a statement to the effect that he asked the question of the specific person and received an answer which he also includes. The reasons for this should be apparent; first, if a question about the item was raised in his own mind, then probably it will be raised in the mind of his superior when he reviews the audit work papers to determine that an appropriate examination has been conducted. Second, during the course of his examination he asks a great many questions of members of the accounting department under review. It is well to have a complete record of those questions and answers in case any inconsistencies appear. Third, if he relies on the answer of the individual to whom the inquiry was directed, he had better have as evidence a record of what that individual replied to his question.

If the work papers are to include a record of all the auditor's verification efforts they will quite obviously include a wide variety of information and evidence. Statements of work done, records of questions asked and

answered, reconciliations, summaries of accounts, confirmations, and a great variety of other material are all included in a good set of audit work papers.

The second important point about audit work papers is that not only must they be complete; they must also give adequate support to the auditor's professional opinion. Any assertion made in his report or even implied in his report or opinion must be adequately supported by the work papers which he has accumulated to support that opinion. Infrequently, yet often enough to be of importance, an auditor's opinion is questioned by someone who feels that he relied on it and suffered material damage thereby. It is then necessary for the auditor to support his opinion as being that of a competent professional man and based on an adequate examination. His work papers become the evidence he must rely on to establish that fact either in or out of court. Many experienced auditors use as their guide to obtaining suitable work papers the question: "Will these be accepted as sufficient evidence in court?" If one continually asks himself a question of that nature and then attempts to answer it conscientiously he is on the right track in so far as obtaining complete work papers is concerned.

Types of Information in Work Papers. If one gives this matter of work paper information serious consideration, it becomes apparent that there are two different types of data which must be included. First are such data as are necessary to enable the auditor to write an informative report; second are data which indicate the verification applied by the auditor. We might call these "account information" and "account verification."

In an informative and interesting report an auditor will include in addition to financial statements various subsidiary schedules pointing out important relationships and facts about the enterprise examined. To do this he must collect considerable information about the company's assets, liabilities, incomes, expenses, and ownership claims. This information he will collect and include in his work papers so that he has it for later review and reference in support of the report. Although considered to be a part of the audit work papers, these data, unless verified, do not contribute to the real end of the examination, which is the expression of an opinion on the reliability of the information presented in the report. Hence a second type of information is a must in the audit work papers; this is the account verification.

It is verification that makes an examination an audit. It is likewise verification that makes a set of work papers adequate evidence. Unless

the verification techniques applied are described carefully and specifically, there is no proof in the work papers that the accumulated account information is either accurate or reliable. Almost any experienced auditor who has reached the level where he reviews the work of others can recall instances when he was presented with what appeared to be a beautiful set of work papers, papers filled with useful information required for report purposes, but work papers which could not be accepted because the essential verification was either absent or woefully incomplete. The collection of information and the performance of verification techniques are entirely different, and, without the proof of adequate verification, audit work papers cannot support an auditor's professional opinion, which is the reason for their preparation in the first place.

Use of Tick Marks. To indicate the nature and extent of verification applied in any specific instance it is common practice for an auditor to use what are called "tick" marks. These are merely odd and distinctive characters made with pen or pencil and intended to have a special meaning. For example, if an auditor has examined the invoices supporting every item in a column of figures he will place a distinctive tick mark of some kind (or or , etc.) after each item listed on his work sheet as he examines it. Then at the foot of the work sheet or in any available space on it he will explain the peculiar significance of that particular mark:

Original invoices examined, all appear proper.

If he then proceeds to prove the footing of the column, another tick mark and another explanation are called for.

Most auditors use colored pencils for tick marks so they will stand out and be discovered easily. Use of various colors makes it possible to repeat the same type of mark but in a different color so that a long line of elaborate marks is not necessary.

Some auditors follow the practice of using a uniform set of tick marks throughout an examination. That is, wherever used, a given mark means the same thing. Others use tick marks to mean anything suitable at the time, and on each work sheet they indicate the significance of the marks used on that page. Each method has some advantages, although the latter is probably more common. The important point is that the meaning of each mark used must be fully understood by the auditor and clearly indicated in the work papers.

Use of Prior Year's Work Papers. An unfortunate practice or habit of work requires comment at this point. In approaching an audit examination, it is general practice for an auditor to arm himself with the working papers prepared during the examination for the previous year. In instructing his assistants as to what their assignment is, many auditors in charge merely give the assistant the work papers for the preceding year and tell the man to do the same work for the current year. There is nothing very improper about such a practice unless the assistant is inexperienced to such a degree that he must follow last year's work in detail. If so, he may merely take the old papers and reconstruct them to include the amounts for the current year. This is certainly not the attitude with which an audit problem should be approached.

The work papers for the previous year should always be examined as indicative of the kind of difficulties which were found that year and the solutions which were worked out. But from there on the auditor should work as independently as possible. He should put his own wits to work to decide what problems he has this year and what form of work paper will help him accumulate the evidence he needs to verify the particular item under consideration. There is nothing sacred about last year's audit work papers. If they are good we may use the ideas contained in them. One should seldom copy them point for point. It is a rare set of work papers which cannot be improved on by the audit staff in the following examination.

Types of Audit Work Papers. If work papers are to be the means whereby audit evidence is collected it follows that they must assume a wide variety of forms and arrangements. A work paper is any record which the auditor makes of his work or findings for the purpose of substantiating his opinion. They range all the way from the type of work sheet common in general accounting that provides for a trial balance, adjustments, and adjusted trial balance, profit and loss, and balance sheet columns to a simple page of notes taken to record a discussion, or the pertinent terms of a contract.

There are very few, if any, set forms for audit work papers. Some firms have developed traditional styles of work papers which they have found highly satisfactory and which they encourage their men to follow. But even such traditional forms must vary considerably from one engagement to another. An auditor is constantly faced with new problems which require the development of new work paper arrangements or the

expansion of old ones. One mark of a good auditor is his ability to devise work paper forms as needed for any verification or data collection problem which may confront him.

Work paper style differs considerably among auditors, and frequently any one of several different possibilities is entirely satisfactory. The best form is that one which combines the necessity for collecting information with the verification of the data collected. Throughout the succeeding chapters of this book examples of work papers will be illustrated. In every case they are suggestions as to how the particular problem may be handled; they are certainly not models to be followed in every case. One must keep his mind alert to the possibilities of modifying such papers when a specific situation warrants so that they may be suitable for more complex variations of the simple situations assumed here.

Contents of a Work Paper File. To illustrate the variety of work paper form and arrangement, it may be desirable to discuss the various types which may be included in a file of work papers accumulated during the course of an audit examination. This is not intended to be in any way a standard set of work papers; rather it is an attempt to illustrate some of the possibilities with which an auditor must be familiar. In other sections of the book other work paper forms will be illustrated and explained.

The following are among the items to be expected in any typical work paper file:

1. Review of internal control.
2. Audit program.
3. General ledger trial balance.
4. Adjusting journal entries.
5. Account analyses.
6. Excerpts of minutes, contracts, etc.
7. Miscellaneous reconciliations, summaries, etc.
8. Rough draft of audit report.

As these represent common types of audit papers it may be well to give each of them a little attention at this point so that when they are referred to again their appearance and use will be somewhat familiar.

Review of Internal Control. The subject of reviewing the internal control system of the company under examination is discussed at some length in Chapter 5 and will only be touched on here. However, the

audit record which results from reviewing the system of internal control is a basic work paper and one deserving of attention.

Some firms provide their staff auditors with forms or questionnaires to be completed in reviewing internal control. Others give their men only a series of items to be covered and expect them to write up a description of the system in effect organized around the suggested outline of items. Still others leave both method and coverage to the individual auditor in charge of the examination and require only that a complete description be included in the work papers. Thus we may find a question and answer type form, a booklet with paragraph headings with the paragraphs filled in by the auditor, or we may find nothing but a series of sheets of paper covered with the auditor's description of the internal control system in effect.

Whether a printed form is used or not, it is generally necessary for the auditor to add sheets of his own writing in order to cover properly all phases of the system he finds. Thus a series of paragraphs of descriptive material are the basic work paper for the review of internal control. In addition, the auditor may find it advisable to prepare a chart of the company's organization showing the lines of authority and the division of duties and responsibility. Additional charts to show the flow of business papers or to diagram the company's productive processes may also be included as helpful. In some cases it is desirable to attach copies of certain of the concern's business forms, such as sales invoices, voucher checks, remittance advices, petty cash vouchers, and requisitions. These make it possible for one studying the internal control system to visualize more clearly the actual flow of data, the methods of approval at various stages, and the relationship of the documents to the ledger accounts.

It is apparent from this brief description that an auditor's work papers summarizing his review of a system of internal control are considerably different from what we often think of in basic accounting courses as a work sheet. They are indeed different, and the reason for this is that they are a specialized type of work paper designed to collect and retain a certain type of evidence. Many other examples of specialized work papers to collect specialized types of evidence will become familiar before one proceeds very far into the field of auditing.

Audit Program. An audit program is the overall plan of attack which the auditor intends to follow in his attempt to gather sufficient evidence to permit him to offer an informed opinion. It is both a summary of all that must be done before he will be satisfied that all aspects

of the financial data have been investigated and a list of detailed instructions to his assistants.

The program is first conceived by the individual in charge of the audit. In view of the opinion he is expected to express and the peculiarities of the given business under study he works out the various detailed verification procedures which he feels are applicable. These are then written out in such a manner that they can be followed by his assistants and serve as instructions to them to be supplemented by oral discussions if either the assistants or the auditor in charge feel further explanation is necessary.

As a part of the work papers, the audit program is important first in that it presents the blueprint followed by the audit staff in performing its verification procedures. The extent of the work which they determined as necessary in the specific case is shown in the program. Second, it serves as a record of the actual performance of those steps. That is, if properly set up, the work sheet will show not only what is to be done but will provide room for the individual doing each step to sign his name or initials together with the date on which the work was done. Thus each step signed for by someone on the audit staff is evidence that that particular procedure has not only been provided for in the plan of attack, but has also actually been completed. Thus during the course of the examination it provides a record of work to be done and work already done, a continuous progress chart of the examination.

General Ledger Trial Balance. The general ledger trial balance, frequently called a "working trial balance," is the heart of the audit work papers. All other analyses relate to it in some way, and all audit adjustments are posted to it. From it is prepared the financial statements which make up a major part of the final report.

Various forms or arrangements of general ledger trial balance are in use and are preferred by individual auditors. The matter of selecting one work paper organization as against another is largely a matter of personal preference; each method has certain advantages and disadvantages. Two of the most commonly used forms are illustrated on accompanying pages.

Whatever form is selected, certain essentials should be provided for. These include:

(*a*) The complete title of each ledger account together with the account number, if numbers are used. At various times during the course of the examination questions will arise as to exactly what accounts the company uses. The general ledger trial balance is the best ready source

of information which the auditor has. To prevent confusion in preparing adjusting entries to be recorded by the concern's bookkeeper it is best to use the same titles used by the company; only if those titles are present in the trial balance will their precise wording be available.

(*b*) A column for supporting work sheet numbers to provide a basis for indexing the work papers. Most of the important accounts in the trial balance will have detailed work papers, usually in the form of account analyses or reconciliations, supporting them. In order that the support for the final figures may be located with a minimum of difficulty, an indexing system tied in with the general ledger trial balance is necessary.

(*c*) The trial balance as of the same date a year ago. The amounts in these columns give a basis for valuable comparisons of amounts for this year with amounts for the preceding period. As described in Chapter 3, comparison is a technique which an alert auditor employs constantly. Comparative trial balances for this and the preceding period facilitate the application of this particular type of scrutiny.

(*d*) The trial balance for the period under examination. These are the data upon which an opinion is to be given and are perhaps the most important part of the work sheet.

(*e*) Provisions must be made for entering or posting audit adjustments to the book figures. Columns for debit and credit adjustment make this possible.

(*f*) The trial balance per books as modified by the audit adjustments are those which are finally included in the financial statements. Thus provision must be made for arriving at an adjusted trial balance.

These are the only columns essential in the general ledger, or working, trial balance. Others may be used but are seldom required and frequently are not at all helpful. It is a fairly common practice to include a pair of columns for profit and loss accounts and another pair of columns for balance sheet accounts so that the accounts in the adjusted trial balance can be sorted out into the major statements into which they will be entered. This is particularly helpful if the trial balance is arranged alphabetically or on some basis other than logical financial statement order. But very few general ledgers are organized in anything except statement order these days, so it is seldom necessary to use such additional columns, and it is often desirable to avoid the complications which necessarily result from their inclusion.

Of the two arrangements illustrated, the second appears to have definite advantages. By reducing the number of columns used, the proba-

Clement Company
General Ledger Trial Balance
December 31, 1954

	Work Sheet No.	12/31/53 Per Audit Dr	12/31/53 Per Audit Cr	12/31/54 Per Books Dr.	12/31/54 Per Books Cr.
Petty cash	A	27700		40000	
Cash - general	B	4220800		4513000	
Marketable securities	C	2825000		1525000	
Accounts receivable	D	16582400		23490000	
Estimated uncollectable accounts	D-1		185000		148000
Buildings	G	85740000		96884000	
Accrued depreciation - buildings	G-1		23949700		24730000
Goodwill	K	10000000		10000000	
Accounts payable	AA		18753200		23788100
Notes payable	BB		50000000		1000000
Capital stock - common	MM		40000000		40000000
Earned surplus	NN		19658200		13358200
Sales			305290100		354858500
Sales returns and allowances		3642700		2864200	
Purchases		198969300		235112700	
Freight and transportation		4061200		4151600	
Depreciation of building	G-1	600000		600000	
Sales salaries		20264400		28648600	
Miscellaneous office expense		261200		276600	
Dividends received	C		850000		250000
Rent received			180000		210000
Miscellaneous income			111000		98000
Provision for Federal income taxes	GG	7800000			
		456184200	456184200	468981400	468981400
Net income					

Illustration 1. General

bility of entering amounts in the wrong column when posting or extending amounts across the work sheet is reduced. Also, valuable work sheet space useful for notes and comments is saved. Again, the section totals for assets, liabilities, and expense groups are determined before the financial statements are prepared so that if errors are made in statement preparation the error can be localized and more readily discovered.

RAM 2-7-55

12/31/54

Adjustments Dr	Adjustments Cr	Per Audit Dr	Per Audit Cr	Profit and Loss Expense	Profit and Loss Income	Balance Sheet Asset	Balance Sheet Liability
	(1) 14900	25100				25100	
		4513000				4513000	
		1525000				1525000	
	(3) 845000	22645000				22645000	
	(4) 69000		217000				217000
		96884000				96884000	
(8) 180300			24549700				24549700
		10000000				10000000	
(12) 210000			23578100				23578100
			1000000				1000000
			40000000				40000000
			13358200				13358200
			354858500		354858500		
		2864200		2864200			
(15) 48971300	(14) 61511700 (9) 171200	222401100		222401100			
		4151600		4151600			
		600000		600000			
		28648600		28648600			
(1) 4800		281400		281400			
			250000		250000		
			210000		210000		
			98000		98000		
(17) 19200000		19200000		19200000			
74644300	74644300	451214700	451214700	338010700	355684100		
				17673400			17673400
				355684100	355684100	213841700	213841700

ledger trial balance.

As might be expected, variations of each of these arrangements are in use, some of them extremely elaborate. Whether one decides that one of the methods illustrated or some entirely different arrangement is to be used, he will do well to give serious thought to selecting the general ledger trial balance form he prefers. During the course of his examination he will have occasion to refer to the trial balance a great

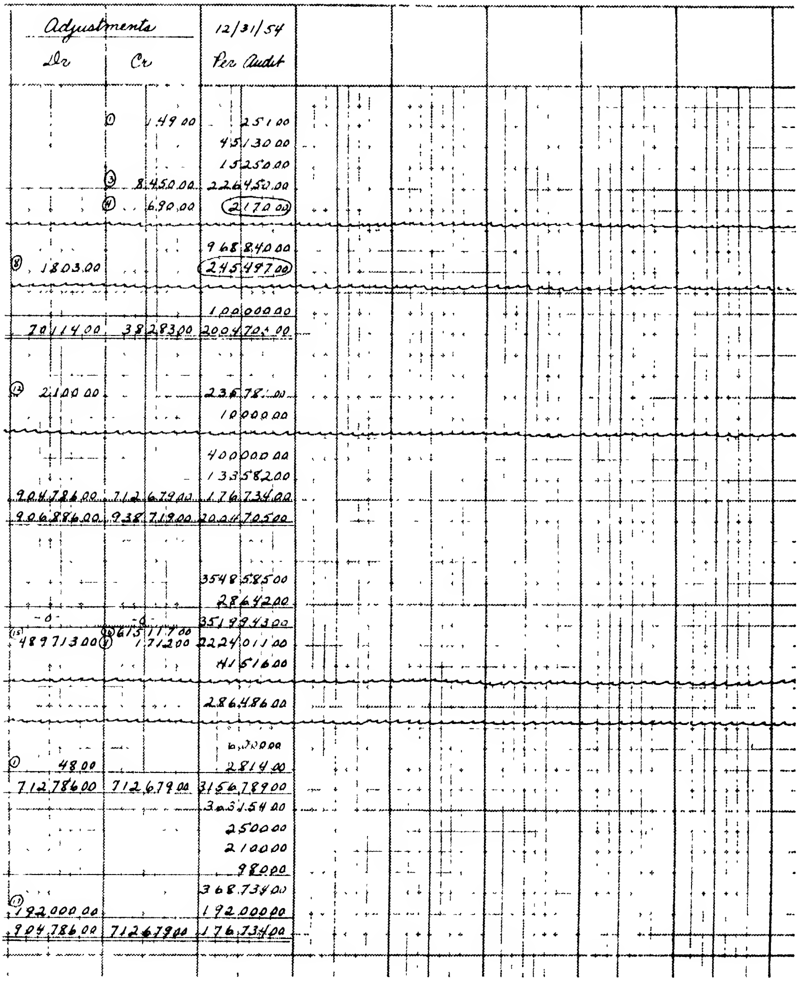
Clement Company
General Ledger Trial Balance
December 31, 1954

	Work Sheet Number	12/31/53 Per Audit	12/31/54 Per Books
Assets			
Petty cash	1	277.00	400.00
Cash - general	2	42,208.00	45,130.00
Marketable securities	3	28,250.00	15,250.00
Accounts receivable	4	165,824.00	234,900.00
Estimated uncollectable accounts		(1,850.00)	(1,480.00)
Buildings	10	857,400.00	968,840.00
Accrued depreciation - buildings		(237,447.00)	(247,300.00)
Goodwill	18	100,000.00	100,000.00
Total assets		1,968,425.00	2,015,170.00
Liabilities			
Accounts payable	21	187,532.00	237,881.00
Notes payable	22	50,000.00	10,000.00
Capital stock - common	33	400,000.00	400,000.00
Earned surplus	35	63,159.00	133,582.00
Net income for the year		133,423.00	368,841.00
Total Liabilities		1,968,425.00	2,015,170.00
Income and Expense			
Sales	51	3,052,901.00	3,548,585.00
Sales returns and allowances		36,427.00	28,642.00
Net sales		3,016,474.00	3,519,943.00
Purchases		1,989,693.00	2,351,127.00
Freight and transportation		40,612.00	41,516.00
Sales salaries		202,644.00	286,486.00
Depreciation of building	10	6,000.00	6,000.00
Miscellaneous office expense	78	2,612.00	2,766.00
		2,816,361.00	3,156,682.00
Net profit on operations		200,113.00	363,261.00
Dividends received	3	8,500.00	2,500.00
Rent received		1,800.00	2,100.00
Miscellaneous income		1,110.00	980.00
		211,423.00	368,841.00
Provision for federal income taxes	29	78,000.00	-0-
Net income		133,423.00	368,841.00

Illustration 2. General

many times and for a variety of reasons. No single work sheet is used more than this one, and a sound order and arrangement is of real assistance.

Adjusting Journal Entries. During the course of his examination an auditor generally finds errors which he feels require correction.



Adjustments Dr	Adjustments Cr	12/31/54 Per Audit
	(1) 1,490.00	251.00
		45,130.00
		15,250.00
	(3) 8,450.00	226,450.00
	(4) 690.00	(2,170.00)
		968,840.00
(8) 1,803.00		(245,497.00)
		100,000.00
70,114.00	38,283.00	2,004,70[illegible].00
(12) 2,100.00		236,78[illegible].00
		10,000.00
		400,000.00
		133,582.00
904,786.00	712,679.00	176,734.00
906,886.00	938,719.00	2,004,705.00
		3,548,585.00
		28,642.00
-0-	-0-	3,519,943.00
(15) 489,713.00	(16) 615,117.00 (4) 1,712.00	2,224,011.00
		41,516.00
		286,486.00
		6,[illegible]00.00
(1) 48.00		2,814.00
712,786.00	712,679.00	3,156,789.00
		303,154.00
		25,000.00
		21,000.00
		9,800.00
		368,734.00
(11) 192,000.00		192,000.00
904,786.00	712,679.00	176,734.00

ledger trial balance.

Journal entries to correct the accounts are then drafted and later submitted to the company's staff for discussion and acceptance. To keep a record of all adjustments recommended, a work sheet is prepared which consists of a copy of every adjusting entry recommended by the auditor. Thus it resembles a general journal. From it the auditor posts to the general ledger trial balance in order to obtain the "per audit" figures.

He also submits either his journal entry work sheet or a typed copy of it to the company's bookkeeper so that the latter can record in the company's journal the recommended adjustments.

A series of journal entries is so simple a work sheet as to require little or no explanation. Two comments, however, may be worth attention. The first has to do with the drafting of the entries themselves. Care should be taken to insure that the entries are complete, intelligible, and fully explained. Frequently the entries are received by the company bookkeeper and recorded after the auditor has left the premises and is no longer readily available to explain questionable points about the entries. Any unexplained or questionable entries will give the bookkeeper little reason to receive either the entries or the next visit of the auditor with any enthusiasm.

An auditor can complete his work with ease and accuracy only if he has the whole-hearted cooperation of the company's accounting department staff. In order to assure such cooperation he must do all in his power to avoid interfering with their work or of making more work for them. One way to do this is to keep their point of view in mind at all times while preparing journal entries. This is particularly true in writing explanations to the entries. During our elementary accounting courses some students become very bored with journal entry explanations and frequently omit them completely. Audit adjusting entries are something of a public relations problem between the auditor and the accounting department whose work he is examining, and he will do well to give them sufficient explanation for each entry so that they can understand and accept it without question.

The second comment has to do with a simple device sometimes employed so that the cumulative effect of the adjusting entries on the concern's net income can be determined at any time. This consists of adding a third column to the journal entry work sheet. The first amount in this column is the net income per books before any adjustments have been made. As adjustments are made, the effect of each one, plus or minus, is carried into the third column so that a running subtotal can be carried to indicate what the profit is after considering all adjustments made to date. This is particularly helpful when adjustments are necessary which are based on the adjusted income figure. For example, an entry to record the provision for federal income taxes requires knowledge of the adjusted net income figure. If that is available in the journal entry work sheet the adjustment can be made promptly. Otherwise it must be com-

Clement Company
Adjusting Journal Entries
December 31, 1954

RSM
2-7-55

	Dr	Cr.	Profit per books as adjusted
Net income per books			# 1 33423 00
① (Reverse 1/1/55)			
Stationery and Supplies	18 65		
Miscellaneous General Expense	19 23		(47 91)
Transportation - In	10 03		1 33375 09
Petty Cash		47 91	
To clear petty cash of non-cash items at 12/31/54, see Analysis (1-a)			
②			
Miscellaneous Office Expense	18 80		(18 80)
Cash		18 80	1 33356 29
To record bank charges for December, see Analysis (1-b)			
③			
Reserve for Uncollectable Accounts	1525 00		
Accounts Receivable		1525 00	
To write off accounts considered uncollectable at 12/31/54, See Analysis (3-c)			
④			
Machinery and Equipment	469 50		(469 50)
Maintenance and Repairs, Mchy + Equip.		469 50	1 32886 79
To correct entry made for Voucher #5-72 capitalized in error See Analysis (16)			
⑤ (Reverse 1/1/55)			
Accrued Interest Receivable	69 80		69 80
Interest Income		69 80	1 32956 59
To record interest accrued on notes receivable at December 31, 1954. See Analysis (14)			
⑥			
Purchases (Reverse 1/1/55)	1650 00		(1650 00)
Office Equipment	420 00		1 31306 59
Accounts Payable		2070 00	
To enter liabilities incurred but not recorded at 12/31/54 (Vouchers 1-7, 1-14 dated 1/3/55 and 1/8/55) See analysis (28)			

Illustration 3. Adjusting journal entries.

puted either by completing the general ledger trial balance or by separate calculation.

Account Analyses. The bulk of the audit work paper file is made up of account analyses. Every important balance sheet account and many of the income and expense accounts will be analyzed and their com-

Clement Company
Delivery Equipment
1954

RSM
2-7-55

Acct #16

			Voucher	Vendor		
		Balance per aud. 12/31/53				46480 00
		Additions				
1	18	Dodge panel truck (No 21)	1-27	Sutton Motors	2850 00 ʰ	
3	17	Tires - Ford pick-up (No 14)	3-22	Tire Supply Store	165 00 ᵘ	
4	12	Dodge truck (No 22)	4-41	Sutton Motors	3100 00 ʰ	
9	16	International truck (No 23)	9-32	B & G Garage	3640 00 ʰ	
11	10	International truck (No 24)	11-48	B & G Garage	3640 00 ʰ	13395 00
						59875 00
		Retirements				
4	12	Ford truck (No 14)			2870 00 ✓	
9	16	Ford truck (No 12)			2870 00 ✓	5740 00
		Balance per General Ledger 12/31/54				54135 00
		Less A J E (21) to transfer cost of tires to maintenance and Repairs. See Analysis (43).				165 00
		Balance per audit 12/31/54				53970 00

ʰ Voucher with supporting invoice examined - appears to be proper addition to fixed assets

✓ Journal entry examined; Traced to subsidiary property ledger - entry appears proper.

ᵘ Company follows policy of expensing tires as purchased - should not have been capitalized

Illustration 4. Work sheet for analysis of Delivery Equipment account.

ponent details verified either completely or on a test basis. No set form for such account analyses is practical as they must be varied to meet the given situation. Frequently several related accounts can be analyzed together; at other times only a single account will require several pages of work sheet data. A typical analysis is illustrated on this page.

Such an analysis must contain all the required information, of course, but it must also contain all the verification procedures applied to deter-

Clement Company
Accrued Depreciation - Delivery Equipment
1954

RSM 2-7-55

Acct # 17

Balance per audit 12/31/53		26114 00
Less depreciation on trucks retired		
No 14 - Fully depreciated - 5 yrs at 20%	2870 00 ∧	
No 12 - Four years at 20% a year - cost $2870	2296 00 ∧	5166 00
		20948 00
Add depreciation for the year		
See Analysis P.F (18) in permanent file		8122 00
Per audit 12/31/54		29070 00

T.B # 222

T.B. - Account # 87

	Depreciation Expense	Depreciation Accrued
Depreciation as above	8122 00	29070 00
Per company	7843 00	28791 00
Adjustment required - A.J.E (18)	279 00	279 00

∧ Traced to subsidiary property ledger - accumulated depreciation O.K.

Depreciation rates same as in prior years. Permanent file includes complete fixed asset and depreciation schedules.

Illustration 5. Work sheet for analysis of Accrued Depreciation—Delivery Equipment.

mine the reliability of the required information. It is in this section of the work papers particularly that the details of verification procedures actually applied must be included.

Excerpts of Minutes, Contracts, and the Like. The terms of important contracts are frequently the reason why entries must be made.

For example, a bond indenture may require the establishment of a sinking fund reserve. The auditor must then assure himself that this particular requirement has been met. He therefore must have in his work papers a summary of the pertinent sections of the bond indenture as evidence that the entry as made does fulfill the terms of the agreement.

Important resolutions by the board of directors or stockholders also may have accounting implications and are therefore of interest to the auditor. His work papers to record such facts may consist of nothing more than a series of running notes. They are none the less work papers and provide some of the evidence he must study in arriving at his opinion.

Miscellaneous Reconciliations, Summaries, Etc. These are of such variety that little can be said of them at this point. They include such work sheets as bank reconciliations, summaries of sales by departments or divisions, computations of bonus amounts, and summaries of accounts receivable confirmations sent and returned. Thus they may include only account information, account verification, or a combination of the two.

Rough Draft of Audit Report. As a culmination of his examination an auditor will prepare some kind of a report to those for whom he undertook the engagement. The report may consist of only a report of his findings in the form of a letter, a set of financial statements together with his opinion of them, or a complete long-form report with statements, an opinion, and lengthy comments upon the information contained in the major statements. Such a report must first be prepared in draft form and then usually reviewed by a superior before being typed and submitted in final form. The draft of the report from which the final typed copy is prepared is properly considered a part of the work paper file. In point of time it is the last part of the work papers to be prepared, but is often the first item in the folder because of its importance. All the other papers are prepared as a basis for the report and for the opinion included in the report.

Permanent Work Paper File. It is a common practice to separate the audit work papers into two main divisions. One of these includes all those papers which are of continuing current importance year after year. Such papers as the review of internal control, continuing analyses of such accounts as Surplus, Capital Stock, and fixed assets, frequently the audit programs year after year, and notes on any contracts in effect over a long period such as a bonus arrangement or the terms of a bond

indenture are included. These make up what is called the "permanent file," "carry-forward file," or some other similar title.

The other division is known as the current work paper file and is composed of all the papers for the current year. Before the audit examination is completed and the report written the auditor in charge should remove from the current work paper file those papers and analyses of continuing interest and add them to the permanent file. In preparing for commencement of the examination for any year, the permanent file and the last year's current work paper file will be studied and both are usually taken along on the job for reference purposes.

Work Paper Requirements. Certain mechanical requirements of work papers deserve comment at this time in order that one may begin to develop sound habits of work paper procedure from the beginning. Completeness has already been mentioned. Each work sheet, or group of work sheets if one is insufficient for a given purpose, should be able to stand alone. They must be quite self-explanatory and must contain all pertinent information whether related to financial statement preparation or to verification of the data. Completeness is probably the first and most important rule to be learned and continually observed.

A set or group of work papers should also be carefully cross-referenced. The nature of accounting is such that information at one point in the work papers is frequently related to information at another point. Whenever one work sheet contains information which supports or ties in with another work sheet it is customary practice to so indicate on each of the two papers. For example, in verifying the entries to the Factory Equipment account an item may be found which properly belongs in the Factory Repairs and Maintenance account. On the work sheet for Factory Equipment this amount will be subtracted from the balance per books to arrive at the adjusted balance per audit and explained somewhat as follows:

Balance per books	$78,350.00
Less repairs to machine No. 98 capitalized in error and transferred to Repairs and Maintenance per Adjusting Journal Entry #11—see Analysis 27	429.50
Balance per audit	$77,920.50

On the work sheet for Factory Repairs and Maintenance a similar notation would appear to explain the addition of the amount of the

adjustment to the book balance of that account. The explanation might run "Add repairs to machine No. 98 charged to Factory Equipment in error, Adjusting Journal Entry #11—see Analysis 9."

A prerequisite to cross referencing in this fashion is the establishment of a system of indexing the work papers. This is discussed later in this chapter.

Other requirements of individual work papers are that each sheet have a complete heading consisting of the name of the company under examination, the name of the account analyzed or a description of the audit test which it records, and the date of the examination. Any other important information related to describing the purpose of the work sheet or test may also be included in the heading. Each work sheet should also be initialed or signed by the individual auditors who have something to do with preparing it. This is usually provided for in either the upper right-hand corner or the lower right-hand corner. Provision is made for the initials of the person who prepared the work sheet as well as the one who reviews. Frequently the date the work is completed is recorded along with one's initials in case any question should ever arise as to the sequence or timing of certain verification steps.

To be useful, a work sheet must not only be complete; it must also be legible. Practice varies widely among practicing auditors as to the neatness and preciseness with which they lay out and complete their work paper analyses. Some are extremely careful to produce work papers which are neat in appearance, carefully ruled and headed, and therefore easy to work with and to understand. Others are content to insure that the essentials are included and give little attention to overall appearance. There can be little doubt that a carefully constructed work sheet, neatly prepared, is easier to review and makes a better impression as evidence. There is also the possibility that habits of careless workmanship may lead to careless thinking and therefore inadequate verification.

Work Paper Indexing. If work papers are to be properly cross referenced and filed so that wanted papers may be found easily, some system of indexing them becomes an essential. Each sheet in the file should have an identifying letter, number, or combination thereof which distinguishes it from all the others. This index then identifies the specific sheet and indicates where in the file it may be found.

Various systems of indexing have been used, and undoubtedly a great variety of possibilities exists. Three relatively simple methods are illustrated here; these serve to indicate the basic methods as well as the way

in which any system once adopted can be expanded almost indefinitely. Before entering on a brief description of each of these three methods, it may be well to point out that the indexing system may be confined to only the account analyses or may be expanded to include all papers in the file. Thus the review of internal control, the audit program, and similar papers may be indexed, or the indexing system may be restricted to those analyses which tie in with or support the figures in the working trial balance. In general it is preferable to index all papers in the file.

1. Sequential numbering of account analyses. This is probably the simplest system available and is entirely satisfactory for most small engagements and many large ones. Each account in the general ledger trial balance which is to be verified by analysis is given a number, and that number is placed on the supporting work sheets. If an analysis consists of more than one page, that is cared for by expanding the index number with a dash and an additional digit. For example:

1	Petty Cash
2	Cash in Bank
2–1	Bank reconciliation, First National Bank
2–2	Bank reconciliation, Second National Bank
3	Accounts Receivable

It is apparent that, simple as this system is, it can be expanded almost indefinitely to fit any situation merely by adding a number for each major account or group of accounts. Thus it might be carried on as follows:

1	Petty Cash
2	Cash in Bank
3	Accounts Receivable
4	Provision for Uncollectible Accounts
5	Notes Receivable
6	Inventories
7	Unexpired Insurance
8	Supplies
9	Long-Term Investments
10	Land
11	Buildings
12	Machinery and Equipment
13	Office Furniture and Equipment
14	Goodwill
15	Notes Payable
16	Accounts Payable
17	Accrued State and Local Taxes
18	Accrued Federal Income Taxes
19	Accrued Wages and Salaries

20 Withholding Taxes Payable
21 Accrued Interest Payable
22 Bonds Payable
23 Capital Stock, Preferred
24 Capital Stock, Common
25 Reserve for Contingencies
26 Paid-In Surplus
27 Retained Earnings

Additional numbers can be added for income and expense accounts for which special analyses are made. Thus a Sales analysis might be numbered 28, and one for Purchases 29. Those income and expense accounts that are verified in connection with some balance sheet account, such as Bad Debts in connection with the account Provision for Uncollectible Accounts, can be given the same basic number as the balance sheet account or a separate number, if desired. Analyses for Accrued Depreciation and similar accounts can be given subsidiary two-digit numbers as illustrated previously for the subsidiary analyses in the cash group. For example, the analysis of Accrued Depreciation of Buildings might be numbered 11–1. Thus it is apparent that one of the real advantages of this simple system is its great flexibility.

2. Combination of letters and numbers. Under this plan letters are given to major sections of the work papers or to major account groups with numbers used to expand the indexing within each group.

A	Draft of audit report
B	Review of internal control
C	Audit program
D	Adjusting journal entries
E	Cash
E1	Petty Cash
E2	Cash in Bank
E2–1	Bank reconciliation, First National Bank
E2–2	Bank reconciliation, Second National Bank
F	Accounts Receivable

Again, the possibilities for expansion are apparent.

3. Digit system. Variations of this system are in use, but one simple application may suffice to indicate its general nature. At first acquaintance it appears somewhat more complicated than the preceding examples but actually there is little basic difference.

Each index number consists of four digits. The first two indicate the account or other material included under that index number; the last two indicate the specific page within the group. For example, in the number 2034, the 20 indicates the account group, Cash, and 34 indicates the

thirty-fourth sheet within the group of work papers for Cash. The first digit may be used further to indicate the section within the financial statements. Thus a first digit of 2 may signify current assets, 3 may indicate permanent investments, etc. This may be illustrated as follows:

1000	Draft of audit report
1100	Audit program
1200	General ledger trial balance
1300	Adjusting journal entries
2000	Cash
2001	Count of petty cash
2002	Bank reconciliation, First National Bank
2003	Bank reconciliation, Second National Bank
2100	Accounts Receivable

Some auditors adopt a uniform indexing system to be used on all jobs. This has an advantage in that one knows, for example, that the fixed asset accounts may always be found under the index letter H or perhaps under 3200 if the digit system is used. It is particularly helpful when work papers prepared at a number of branch offices are brought together for review or consolidation. Of the three systems illustrated, the combined letter and number system and the digit system appear to be most readily adapted to use as a uniform system.

PROBLEMS—CHAPTER 4

Problem 4–1. From the following trial balance of Young & Company, Inc., before closing of its second year June 30, 1953, and from the additional data given, prepare (1) adjusting journal entries in good form, and (2) a columnar work sheet showing in separate columns the adjustments applied to the trial balance and the resulting adjusted balances. Prepare your work sheet with sections for assets, liabilities, income, and expenses.

Trial Balance

Cash	$ 52,475	
Accounts Receivable	320,000	
Reserve for Bad Debts		$ 650
Materials and Goods in Process, June 30, 1952	65,000	
Finished Goods, June 30, 1952	158,000	
Insurance Unexpired, June 30, 1952	3,000	
Land	200,000	
Buildings	300,000	
Reserve for Depreciation of Buildings		6,000
Machinery and Equipment	148,500	
Reserve for Depreciation of Machinery and Equipment		11,250
Reserve for Replacements		15,000
Sinking Fund Trustee	25,000	
Discount on Bonds	25,000	
Treasury Stock	35,000	
Accounts Payable		40,000
Bond Interest Accrued		3,125
Taxes Accrued		9,000
First Mortgage 5% Sinking-Fund Bonds		226,250
Capital Stock		500,000
Premium on Capital Stock		50,000
Stock Donation		60,000
Reserve for Bond Sinking Fund		25,000
Surplus, June 30, 1952		60,000
Sales, less returns and allowances		913,000
Scrap Sales		1,500
Miscellaneous Income		500
Purchases of Materials	305,000	
Labor	132,800	
Operating Expenses, Repairs, Etc.	121,500	
General Expenses	17,500	
Bond Interest	12,500	
	$1,921,275	$1,921,275

Additional Information. 1. The $500,000 share capital had been issued at a 10% premium to the vendors of the property on June 30, 1951, the

date on which the company was organized. Stock in the amount of $60,000 par was donated by the vendors and was recorded as a debit of that amount to "Treasury Stock" and a credit to "Stock Donations." It was donated because land and buildings had not been valued accurately when entered on the books, and the proceeds were to be considered as an allowance on the purchase price of land and buildings in proportion to their values as first recorded. The stock was sold in the latter part of 1951 for $25,000, which amount was credited to "Treasury Stock."

2. On June 30, 1953, a machine which cost $6,000 when the business was started was removed and replaced by a similar machine costing $10,000, which amount was charged to "Operating Expenses, Repairs, Etc." The replaced machine had been depreciated at 7½% during the first year. The only entry made was one crediting "Machinery and Equipment" with its sales price of $1,500.

3. Depreciation of buildings is to be provided at 2% annually and machinery and equipment at 7½%.

4. The inventories at June 30, 1953, were:

Materials, cost	$ 52,000
Goods in process, cost	105,000
Finished goods, cost	137,000

5. The company decided to maintain a reserve for bad debts equal to 1% of the accounts receivable outstanding on June 30. Accordingly $3,000 had been set aside at June 30, 1952, against which the bad debts of the year ended June 30, 1953, had been written off.

6. Three years' insurance is carried on buildings, machinery, and equipment, and a premium of $4,500 had been paid on July 1, 1951.

7. The first-mortgage 5% sinking-fund bonds mature in ten years from July 1, 1951, with interest payable on April 1 and October 1. They were sold July 1, 1951, at 90, and the discount is to be written off over the life of the bonds on the straight-line basis.

8. A sinking fund and sinking-fund reserve are built up on the straight-line basis with a provision that installments after the first shall be decreased by the amount of the annual 5% interest accretion to the fund, which interest is to be added both to the fund and to the reserve.

9. It is learned from the records that the proper installment to the sinking fund was paid by the company on June 30, 1953, but that the amount was charged in error to the First-Mortgage 5% Bonds account.

10. The sinking-fund trustee reports that he added $1,250 interest to the fund on June 30, 1953. This has not been recorded by the company.

11. During the year ended June 30, 1953, taxes were charged at $3,000 monthly to "Operating Expenses, Repairs, Etc." and "Taxes Accrued" was credited. The taxes paid during the year amounted to $27,000. The taxes are assessed each time for the year ended March 31.

12. A dividend of 10% on the outstanding stock was declared June 25, payable July 15, 1953. (AIA adapted)

Problem 4–2. You are called on to audit the books of account and records of the Van Tress Mills for the year 1953 and are given a copy of the trial balance, taken from the books as at December 31, 1953, before closing, which is as follows:

TRIAL BALANCE

Cash in Bank and On Hand	$ 12,205	
Accounts Receivable	118,496	
Yarn	28,607	
Goods in Process	104,293	
Supplies	9,467	
Fuel	275	
Finished Goods	99,097	
Insurance Prepaid	904	
Interest Prepaid	1,205	
Plant and Equipment	276,433	
Accounts Payable		$ 55,535
Notes Payable		110,000
Labor Accrued		1,521
Reserve for Depreciation		29,875
Reserve for Contingencies		2,000
Capital Stock		206,000
Surplus		104,456
Labor, Weaving	55,234	
Labor, Finishing	20,429	
Supplies Used	4,210	
Repairs to Machinery	3,407	
Power and Light	10,249	
Fuel	5,200	
Insurance	1,620	
Taxes	4,194	
Depreciation	9,998	
Factory Overhead Applied		161,908
Sales		641,455
Discounts and Allowances	2,788	
Cost of Goods Sold	482,018	
Commissions, Selling	24,298	
Salaries, Executive	8,783	
Salaries, Office	6,104	
Office and General Expenses	1,684	
Interest	7,132	
Dividends on Preferred Stock	14,420	
	$1,312,750	$1,312,750

In the course of the audit you discover (1) that machinery which cost $4,280 was sold for $1,720 cash, and this amount was credited to Plant and Equipment account (depreciation taken thereon amounted to $1,284); (2) that among the accounts receivable an account of $12,925 for goods billed at regular selling prices actually represented merchandise on consignment (the inventory value of this merchandise was determined to be $8,404); (3) that Prepaid Insurance was overstated to the extent of $121; (4) that depreciation charged was overstated by $624; and (5) that Accrued Labor (Finishing Department) was understated by $506.

Before making the corrections necessary from the above findings you decided to verify the inventories and make an analysis of the merchandise accounts. From this analysis, you establish the following:

Goods in Process (Manufacturing)

Inventory, January 1, 1953	$103,802	
Yarn used	317,805	
Overhead applied	161,908	
Finished goods transferred (see below)		$477,164
Waste sold		2,058
Inventory, December 31, 1953		104,293
	$583,515	$583,515

Finished Goods

Inventory, January 1, 1953	$103,951	
Merchandise transferred (see above)	477,164	
Cost of goods sold		$482,018
Inventory, December 31, 1953		99,097
	$581,115	$581,115

From the data given and the additional facts disclosed, prepare and submit your working trial balance, together with supporting journal entries, showing all adjustments and the adjusted balance sheet and profit and loss statement amounts. (AIA adapted)

Chapter 5

REVIEW OF INTERNAL CONTROL

In Chapter 2 it was pointed out that the existence of a satisfactory system of internal control is in itself some evidence that the accounting data produced by the accounting department are reliable. To determine the existence of such evidence an auditor must, first, find out exactly what internal control measures are supposed to be in operation, and, second, determine whether or not those measures are functioning effectively and as originally planned when the system was devised. Thus he has much the same type of analytical problem here that he has in general; he must ascertain what certain facts about the business are, and in so doing come to a conclusion as to the reliability of the accounting statements.

Nature of Internal Control. If an auditor is to inquire into the effectiveness of internal control and arrive at conclusions based upon the results of such an inquiry he must first have a sound understanding of what is meant by internal control. For purposes of audit verification it appears best to adopt a broad concept of internal control. Any measures undertaken to assure the accuracy of accounting data or which help to assure such accuracy may well be included as being a part of the internal control.

Some simple examples may help to illustrate the point here. If a company stores its raw-materials inventory in an unlocked storeroom to which employees and others have access so that they can come and obtain such inventory items as they require without the formality of appropriate authorization or record, it is extremely doubtful if any accounting records of goods on hand can long be accurate. If, on the other hand, the storeroom is locked and under the control of an inventory clerk who requires the presentation of a formal requisition, properly approved, before any stock is issued, it is much more likely that accurate records can be kept. Of course, other steps to insure the proper handling of the requisitions and their entry into inventory records are also necessary, but the mere fact that the stockroom is locked and requisitions are required for all issues makes accuracy of the accounting

records more likely. Thus such a simple measure as a lock on the storeroom door becomes a part of the internal control; absence of such a lock is a weakness in the internal control.

A somewhat more complicated situation might exist with respect to cash receipts. If the cashier in a "cash and carry" grocery store receives all cash, then at the end of the day prepares the bank deposit, records the cash in the cash receipts book, and takes the deposit to a bank, the possibilities for error are considerable and the internal control is extremely weak if not completely absent. But with some slight changes considerable improvement can be made. Use of a cash register which not only shows the amount of each sale by a visible indicator but also ejects a sales slip for the customer and makes a copy of each sales slip on a continuous tape within the machine is a beginning. The cashier must then "ring up" the correct amount for each sale or risk complaint by the customer. If, further, that tape is locked within the machine in such a way that the operator does not have access to it, another feature is present to reduce the possibility of error. Now if someone other than the operator unlocks the machine each night, counts the cash in the drawer, and compares that with the receipts for the day as indicated by the cash register tape, it follows that any failure by the cashier to have all cash present will be discovered. The individual counting the cash can then prepare and make the bank deposit. To insure that all the cash he counts is actually deposited, provision can be made to have some member of the accounting department compare the daily totals on the cash register tape with the amounts recorded by the bank as deposits when a bank statement is received at the end of the month.

Once entered in the cash register, the cash must be kept intact in order to agree with the tape when counted at the end of the day. The person taking the cash from the register for deposit must likewise account for all cash received by depositing it, or a discrepancy between the cash register tape and the bank deposits will be uncovered at the end of the month by the accounting department.

Several features of internal control are utilized here. The use of a cash register with a locked-in tape, separation of the duties of receiving cash and making the deposit, review of the work of the cashier by the one making the deposit, review of the work of the one making the deposit by the accounting department, and separate entry of amounts by a member of the accounting department who has no access to the cash itself are all internal control measures that help to obtain accurate accounting records of cash received and on hand.

It should be apparent that internal control does more than assure that the accounting records are accurate. It helps to assure that company assets are not converted to personal use improperly. This may well be the most important function of internal control, but for purposes of outlining the nature and extent of internal control it is well to extend its purpose to such other matters as the proving of accounting records.

Another example may be helpful here. Let us assume that a concern has taken its physical inventory, listed the quantities and the prices of the various items, and is now prepared to extend the quantity times the price and to foot or add the inventory pages. Whether this is done by machine or by hand, the possibility of arithmetical error is present. To guard against such errors it may be advisable to have two separate calculations of every extension and every footing by independent clerks. Thus the arithmetical work is done twice, and only if both results agree will the final figure be accepted. This has nothing to do with protecting the properties of the company as it is purely a clerical matter of arithmetical computation. But if errors are made, the final data are not dependable, and improper decisions based upon such data are possible. So the second or additional computation is another internal control measure.

Thus internal control measures extend beyond the physical protection of company properties although they do include all efforts made to obtain physical protection as well.

Auditor's Interest in Internal Control. If the existence of an effective system of internal control can be viewed as evidence of the reliability of accounting data, then the presence or absence of such a system will indicate the necessity for obtaining either more or less evidence of other types and by other means. That is, if the internal control over cash receipts is excellent, the other verification techniques need be applied to cash receipts only to a very limited extent. On the other hand, if it develops that there is very little internal control over cash receipts, it becomes necessary to apply other techniques extensively in order to obtain as much evidence as possible of the reliability or unreliability of data on cash receipts and cash balances.

It is a truism in auditing that the amount of work to be done, the extent and nature of the audit program, varies directly with the existence and effectiveness of the system of internal control. The less internal control, the more audit tests and verification; the better the internal control, the less extensive will be the audit tests and verifications. Thus

the primary interest of an auditor in reviewing the system of internal control in a company under examination is to determine the extent of other tests and checks which he will include in his audit program.

A word of caution is important here. It was pointed out earlier in the chapter that two steps are necessary in establishing the effectiveness of the internal control actually in operation. First, inquiry must be made of appropriate officers as to what internal control measures they have established within the operations of the business. Then after determining what the control is supposed to be, some tests must be made to discover whether the internal control is actually functioning as it is supposed to be. It is not an uncommon matter to find that control measures have been vitiated by employees who are opposed to what they call "red tape" or who feel that the shortest way of getting something done is the best regardless of whether the short way is the one established by the company authorities. Therefore, after he has ascertained the measures supposedly in effect, an auditor has an additional responsibility to find out whether or not those measures are working effectively.

Based upon his first review of internal control, he can arrive at a preliminary determination of the amount of work to be done or the extent of his audit program. Final determination of the scope of verification must wait until, by means of various tests, he has found the extent to which the internal control in effect compares with the internal control as described.

Determination of the extent of his audit program is the primary purpose for a review of a concern's internal control, but it is not the only one. One of the "by-products" of an audit consists of suggestions by the auditor to the company examined as to ways in which its internal control can be improved. If an auditor finds no lock on the stockroom door, he should recommend that one be used. If he finds inadequate internal control in existence at any other points in the operations of the business he should likewise offer suggestions as to how improved measures might be instituted (to eliminate the possibility for error now present.) Frequently such suggestions are the difference between happy and unhappy relations between an auditor and the accounting department staff. Audit examinations, as discussed in Chapter 1, are a necessity in our business economy. There is, however, very little in the examination itself that appears to the accounting department staff to be constructive. To the extent that an auditor is alert to the possibilities of making additional suggestions which are constructive, he will impress

the staff and officers of the company under examination and will give them reason to anticipate his return with pleasure or reluctance.

Essential Features of Internal Control. As business operations vary considerably in size and type, internal control measures also must vary considerably. It is therefore impracticable if not impossible to attempt to learn the specific measures which should be in effect at every point in every concern one is likely to examine. Instead of attempting to memorize a long list of procedures which may or may not be applicable in a given situation, one should gain an understanding of the characteristics of internal control in general and then use his imagination and his knowledge of the specific business under examination to determine how those characteristics can be adapted to that concern. Frequently there is a variety of ways of obtaining satisfactory control over a given operation or type of transaction. If any one of these contains the essential features of internal control, it may well be satisfactory; absence of those features means it must be viewed with suspicion and additional evidence obtained. To the extent that one understands the basic nature of internal control and has sufficient knowledge of business to see the application of internal control features to the company he is examining, he will be able to make a successful review.

Included within the essential characteristics of satisfactory internal control are the following:

1. Adequate and competent personnel.
2. Separation of record keeping from custodianship and operation.
3. Establishment of responsibility.
4. Preparation of record proof of all work done.
5. Review of work done.
6. Inclusion of adequate physical protection of properties and records.
7. Assurance of mechanical accuracy.

Some brief explanation of each of these may be helpful.

Adequate and Competent Personnel. To anyone familiar with accounting and business it should be apparent that adequate and competent personnel are an essential if satisfactory internal control is to be obtained. Without employees who have appropriate training and skill, who are diligent and careful in their work, and who observe company policies and regulations, internal control can scarcely be achieved. Likewise an understaffed organization will be unable to function as

effectively in this respect as one having enough members to devote the time required to each aspect of the work involved.

Separation of Basic Functions. From the standpoint of internal control, the basic functions of a business are those which involve control over properties and transactions and those which involve the preparation of records of such properties or transactions. Certain persons have under their control the assets of the company. As custodians or as operating employees they have access to the properties and therefore have an opportunity, whether they have any desire or not, to utilize those resources for personal purposes. To ascertain whether they account properly for the assets entrusted to them the company keeps records of the quantities for which they are responsible or accountable. Accountability then is measured by the accounting records. It becomes apparent that, if one is given charge not only of valuable assets but also of the record of those assets, he controls not only the properties but the accountability for them as well. For a record of accountability to be valid it must be maintained by someone other than the person whose accountability is thereby indicated.

For example, if a stock clerk has under his control the contents of a large storeroom of electric appliances and likewise is charged with the duty of keeping the only inventory record of the items in the storeroom, he is in position to cover any shortages which might occur for any reason whatsoever. If he finds that he is short one electric toaster he need only enter an additional credit on the detail inventory card. Then, when time comes to verify the inventory records by actual count of the units on hand, the count and the inventory record will be in agreement. If, however, the record is kept by someone outside the inventory department, a shortage cannot be covered by the one responsible for receiving, issuing, and storing the merchandise in question. With such a division of duties, comparison of the record with a physical count should reveal any shortages.

A basic rule of internal control, therefore, is to separate the function of record keeping from those of custodianship and operation. No person should have control of both an operation and its entry in the books and records, or of properties and the record kept of those properties.

It may be well to point out, further, that not only should the record be kept by a different individual but by an independent individual. Little effective control would result from entrusting the inventory records to an assistant to the inventory clerk or storekeeper. Records must be

kept by someone sufficiently independent to insure that errors discovered will be brought to light.

Establishment of Responsibility. Control measures are likely to become ineffective if those who are responsible for errors can disclaim that responsibility or shift the blame to someone else. On the other hand, knowledge on the part of an individual staff member that he alone is responsible for the final accuracy of the payroll figure, for example, impresses upon him the necessity for care in his work. He knows that any error will be attributed directly to him and that he cannot shift the blame to another.

Responsibility may be divided into two classes. First is responsibility for the safe keeping of assets. The necessity for fixing such responsibility is evident and needs little explanation. The second kind of responsibility is for the performance of duties. It is in fixing and subsequently testing the acceptance of responsibility of this type that internal control measures sometimes fail.

Let us assume a situation in which the individual having the responsibility of signing checks is also required to examine carefully the documentary evidence supporting the check. He is charged with the responsibility of reviewing the invoice, the receiving report, the purchase order, and any other papers which prove the propriety of the disbursement. Further, he is to assure himself that each of these documents has been properly approved as provided by other internal control measures. Signature of the checks supposedly indicates that the individual signing has discharged his responsibility for review of the underlying documents. In actual practice, however, it is not unusual for an individual in that position to become somewhat lax in the discharge of his responsibilities. Perhaps he "trusts" his subordinates; perhaps he has other obligations which allow him insufficient time for this duty; perhaps he is naturally careless, or lazy, or unimpressed by the necessity for review. Whatever the cause may be, if he fails to accept the responsibility for that control procedure, an important weakness in the system results.

Not only must responsibility be assigned to members of the staff, but each of those members must also be convinced of the importance of the procedure assigned to him in order that he might accept and discharge that responsibility properly. Only if individual members of the company's staff both know and respect their responsibilities will the control measures be effective.

Record Proof of All Work Done. Without records of work done no proof that procedures have been followed is available. A person assigned to verify prices and extensions on all purchase invoices may process thousands of invoices during the course of a year. To assure that no specific invoices have been overlooked, some requirement for initialing that invoice or otherwise designating completion of the step which he has performed is essential.

The record made may consist of a formal document, a memorandum, a rubber stamp impression, an initial in a space provided, or any one of a number of other possibilities. Some record must be made, however, if acceptance and discharge of responsibilities are to be indicated. Without such indication there can be no real assurance that the control measures are functioning at all.

Review of Work Done. Record proof of work done makes possible the review of the performance of that work. One who knows that a superior will review the performance of his work is more likely to take performance seriously and to be conscientious in the pursuit of his duties than is one who knows that no one besides himself will ever know if he has done the job assigned to him. Thus, to give assurance that each step has been undertaken and all responsibility appropriately discharged, some provision must be made for reviewing the work of each staff member.

Review may be concerned with the accuracy with which work has been done or may limit itself to finding out whether the person reviewed accepts responsibility for a given procedure. For example, to some extent a physical inventory is a review of the inventory records to determine their accuracy. The person who approves an invoice for payment, on the other hand, will note only that the person responsible for prices and extensions has initialed the invoice; he will not recheck the work. Where there is an important opportunity for errors, some means of review of the accuracy of the work is generally advisable and should be included in the control system. Where the possibility for error on the part of a given employee is not so great, it may be satisfactory merely to review his work to determine that he has indicated performance of the procedure assigned to him.

Review may also be made in detail, that is every step rechecked, or it may be carried out on something of a test basis with only occasional amounts being checked carefully. Frequently test review is quite effective in insuring that procedures are applied carefully and at the same time is not nearly so costly in time and effort as detailed review.

Physical Protection. It seems apparent that every practicable means should be availed of to give valuable assets and records physical protection. Protection includes safeguarding from weather and the action of the elements as well as from theft and misappropriation. The idea can well be extended to include the insuring of valuable assets and the bonding of employees to protect the company from losses due to dishonesty.

A distinction is sometimes made between physical control and accounting control. Physical control results from giving properties such protection as will eliminate damage or theft. It includes the use of storeroom facilities, vaults, night watchmen, issuance only upon the authority of properly approved requisitions, and other devices of that nature. Accounting control requires that the records be tied in carefully with the actual movement of the physical properties. The issuance of items from stores must get into the records promptly; additions must be reflected accurately and as soon as possible. Balances on hand as shown by ledger accounts must agree with the quantity actually in the stockroom. Obviously, accounting control must rest upon physical control. Without adequate control over the movement of the assets themselves, the accounting records are very unlikely to be in agreement with quantities on hand. That is, if an unlocked storeroom permits the theft of valuable inventory items, there is little chance that the accounting record of the amount of that item on hand will agree with the actual situation.

Physical protection is thus one of the most elementary and yet one of the most important characteristics of internal control.

Mechanical Accuracy. A great variety of measures are available to help obtain mechanical accuracy. The double entry system of bookkeeping, the use of subsidiary ledgers and controlling accounts, books of original entry which cross foot, and various other measures of that type are included within the accounting system as commonly set up. In addition there is the use of various calculating and adding machines to reduce the possibility of arithmetical mistakes, and such simple procedures as a requirement for duplicate independent calculations to check one against the other.

In many machine accounting installations provisions are made for obtaining proofs or checks of one amount against another to aid in eliminating mistakes. For example, machine-posted accounts receivable installations will commonly provide for accumulating a total of the

charges or credits posted during a given "run" to be compared with the net change in the account balances at the end of the "run."

The preparation of a bank reconciliation as a way of determining the accuracy of the cash receipts and cash disbursements records is another illustration.

As one gains experience in accounting and auditing, he will become acquainted with more and more methods of assuring greater mechanical accuracy and will begin to watch for such devices. At any point where there is a real chance for important mathematical errors, some type of proof or check should be applied. If no such measure is in use, then another weakness in the internal control has been discovered.

Variations in Degree of Internal Control. The efficiency of any system of internal control is affected by such variables as the number of people assisting in the record keeping, the training and education of those people, and the type of supervision given them. A large, well-staffed company can develop its internal control system to a point well beyond the possibilities for a small concern. In a small company it is sometimes extremely difficult to work out a division of duties which will prevent one person from having more control over transactions and records than is commonly considered desirable. And the possibilities for review of work are almost completely missing.

This is not to say that internal control is always present in a large organization and missing in a small one. The method of organization and the alertness of the management to the internal control problem are also of importance, and many large concerns which have every possibility for good control may worry along with something far less desirable. On the other hand, careful subdivision of duties in a small concern with the owner-manager taking an active part in both operations and record keeping can bring about a reasonably satisfactory internal control situation.

An auditor must be prepared to face situations varying considerably and must know how to determine the extent of and to evaluate the efficiency of the control measures in force.

Auditor's Approach to the Review of Internal Control. In discovering what internal control measures there are in force in a given case, an auditor must realize, first of all, that internal control is a matter of people. People conduct the transactions and make the records. If there are errors, someone must have made them. Thus an auditor is concerned with who does what, so to speak. He must find out what the

company's procedures are for conducting business and for recording transactions as they occur.

Once he has secured that information and has it in some useful form so that he can study it, he must begin to look for weak spots, for possibilities of error which would not be detected or discovered in the ordinary course of business. Again he is concerned with the individuals keeping the records and carrying out transactions. What are the possibilities for error on the part of each person in the organization? Does the person have access to valuable assets? Does the work of that person affect the reliability of the financial statements? These questions must be asked and answered for each person in the organization. If, for example, an employee does nothing but file vendors' invoices, there is little worry about errors which either affect the financial statements or cover shortages of one kind or another. If, however, a person handles cash receipts, posts to customers' accounts, or approves invoices for payment, his work is of interest in the review of internal control.

Once the employees whose tasks are related to control are discovered, additional questions must be asked about each. What opportunity does that individual have to obtain assets or to make errors? What automatic checks exist within the system which will disclose such errors? The person who posts to the general ledger may make errors in posting. If, however, provision is made for obtaining a general ledger trial balance monthly, the possibility of errors is lessened. If, in addition, provision is made for analyzing or proving the balance of certain accounts every year or every six months, another check upon that type of error is included.

Again, if the cashier is assigned the task of depositing all cash received daily, there is always the possibility that he will "borrow" funds either temporarily or permanently. If provision is made for independent comparison of cash received with amounts recorded as deposits on the bank statement, such borrowing will be revealed no later than the end of the month during which taken.

As an auditor obtains answers to these questions he is laying the groundwork for development of his audit program. Where opportunities for errors are either negligible or nonexistent he need apply verification techniques only enough to learn that the system is functioning as described. Where he finds that opportunities for error do exist, and further, that opportunities for concealing or covering the error exist as well, there he must expand his verification until he has reasonable assurance that the errors possible have not been made or until he has discovered the errors that have been made.

The point of view of the auditor in making his review of the internal control is of such importance that it may be well to summarize it as follows: First, he is interested in finding out the duties of the various members of the company organization. Second, he must discover the extent to which each of these persons has access to valuables or the extent to which the financial statements are dependent upon the work of any given individual. Third, when such internal control problem areas are discovered, he must next decide what the possibilities for error are and how those errors might be concealed without discovery. His audit work program must then be organized in such a way as to give major attention to those areas where error is possible without automatic discovery through the functioning of the internal control system in effect.

Methods of Review. As may be clear from the preceding discussio two steps are required in reviewing the system of internal control. First, a description of the system supposedly in operation must be obtained; second, tests must be applied to discover whether that system actually is working as described. The first of these steps is the one generally described as "reviewing the system of internal control." The basic technique which is applied to do this is that of inquiry. Questions are asked of the member of the company's staff best qualified to discuss the topic of internal control, and the answers to those questions provide the auditor with information upon which his preliminary estimate of the internal control situation is based.

This is a very simple statement of a very difficult problem. To sit down with someone and ask him the right questions in the right order to obtain a reasonable understanding of the way in which all the accounting information is collected and of the controls which help to make that information reliable is no easy task. Yet that is precisely the way in which the review must be commenced.

Various methods are in use to aid an auditor in asking the appropriate questions in the proper sequence. One very common method is to supply each auditor with copies of a questionnaire prepared and printed in advance. These questionnaires have been given considerable thought and supposedly contain a well-organized set of carefully integrated questions designed to point out any weaknesses in the system reviewed. Thus some of the responsibility for determining the questions to be asked is shifted from the staff auditor to the person who prepared the original questionnaire. Another method is to give the auditor not a questionnaire but a list of topics and points to be covered. Within the general areas listed he must ask such detailed questions as are pertinent, and he

POINT SHEET FOR REVIEW OF GENERAL CASH
DISBURSEMENT PROCEDURE

In what department are cash disbursements made?

How many signatures are required on each check? Who is authorized to sign checks?

Are checks signed mechanically or by hand? If mechanically, who has custody of signature plate? What steps are taken to protect signature plate from misuse? Is a check protector used to reduce the possibility of raising amounts on checks?

What approvals are required before signatures are attached? What documentary support is submitted with check for signature? What review of reason for expenditure is made by check signers?

Who prepares checks? What authorization is required for check preparation?

What steps are taken in mailing or otherwise distributing checks after signature? Who has access to signed checks?

Who records cash disbursements? What document is basis for entry? What opportunities are available for manipulation of cash disbursements record?

Who prepares bank reconciliations? Who reviews them? Is reconciliation procedure sufficiently independent and thorough to be effective?

Do those who prepare, sign, distribute checks perform any duties or have access to:

- Cash receipts?
- Other cash funds or securities?
- General ledger?
- Voucher or invoice register?
- Vendors' invoices?

Illustration 6. Type of information to be obtained in making review of internal control.

INTERNAL CONTROL QUESTIONNAIRE

Petty Cash

1. Is the imprest fund system used?________
   If not, describe method in use.________
   ____
2. Does the petty cashier obtain a formal voucher for every disbursement from the fund?________
3. Are any approvals for disbursements required?________ If so, describe.________
   ____
4. Are disbursement vouchers submitted for review at time of reimbursement?________
   Describe procedure followed, giving names and positions of all employees concerned.________
   ____
   ____
   ____
5. Are disbursement vouchers canceled when reimbursed?________ Describe procedure followed.________
6. Are amounts for disbursement vouchers spelled out as well as written numerically?
   ________. Are they written in ink?________
7. Are checks for reimbursement made out to the petty cashier?________
8. Does the petty cashier have access to other cash or other funds?________ If so, describe.________
9. Is petty cashier authorized to cash checks for employees?________ For officers?
   ________ For customers?________
10. Is control over cashed checks adequate?________
    ________ Describe procedure followed, including approvals required, disposition of cashed checks by petty cashier, etc.________
    ____

Illustration 7. Portion of an internal control questionnaire.

has the task of adapting his questions to the specific concern under review. Still another practice, which incidentally gives the field auditor the least help, is to permit him complete freedom in the questions he asks; all that is required is a reasonably comprehensive description of control measures employed by the company.

Within the bounds of these three types of review, a host of minor variations is possible. Each has certain advantages and most have some disadvantages. For example, the questionnaire-type review may deteriorate into a mere completion of the form without sufficient care on the part of the reviewer to look into unusual situations or practices. No single questionnaire can be completely adaptable to the wide variety of concerns one meets in practice. On the other hand, to give a man the entire responsibility for organizing and completing his review places a tremendous burden on the staff auditor. This is particularly important when one realizes that the entire examination is based on the review of internal control and that an omission or misunderstanding in the review may fail to disclose a weakness which would have caused serious modification of the work program. A combination of these two extremes is probably desirable. That is, the reviewer should have some kind of "point sheet" about which to organize his questioning without at the same time having a complete, detailed questionnaire to stifle his imagination or interest.

Organization of the Review. In asking the necessary questions, better results will be obtained if a logical order of questioning is followed. In most cases the functioning of a merchandising or manufacturing enterprise can be discussed around two main areas supported by several smaller ones. These are:

1. Purchases, accounts payable, cash disbursements.
2. Sales, accounts receivable, cash receipts.
3. Inventories.
4. Payrolls.
5. Petty cash.
6. Property accounts.
7. Investments.

If the first two of these areas are explored fully in the sequence indicated, most of the concern's transactions and a great part of its accounting problem will be covered. All the remaining five areas are much smaller and more specialized, but each is of importance and must be given attention.

Determining Existence of Controls as Described. The second phase of the review of internal control requires the application of verification techniques to determine whether the system is operating as described. No brief means of doing this can be set out. Throughout the rest of the audit program, steps will be included which aid in determining the efficiency with which the control measures are being followed. For example, in comparing canceled checks with the record of checks issued, an auditor will note whether the proper signatures have been affixed to the checks and if two are required will examine them to make sure that both signers have done so. In reviewing petty cash expenditures he will check to see whether approvals have been given as required. Some of the footings of books of original entry will be undertaken to determine whether cross footings provided for have been made properly.

Thus it is not possible to state exactly how or when the second phase of the review of internal control is completed except to say that it is carried out simultaneously with other parts of the audit program. If in so doing it is discovered that the control is not functioning as described, then expansion of the program will become necessary.

PROBLEMS—CHAPTER 5

Problem 5–1. (*a*) Briefly describe the imprest system for operating a cash fund. (*b*) State the principal advantages of the imprest system from the standpoint of internal control. (*c*) Prepare a detailed questionnaire to be used by your staff employees in evaluating the internal control over a petty cash fund. (AIA)

Problem 5–2. Each of the following paragraphs describes one phase of the internal control of the Acme Artwork Company as indicated. Describe briefly the most outstanding weakness you note in the internal control as described and the improvements you would suggest to strengthen the system. Assume no internal control features beyond those specifically mentioned.

1. *Cash Disbursements.* All disbursements for amounts over $25 must be made by check. Each check on general cash requires the signatures of Samuel Elfson, Treasurer, plus the countersignature of either N. C. Ford, President, or M. L. Lakota, Vice President. As these latter two do considerable traveling, they frequently sign blank checks when they expect to be away for a few days and leave them with Elfson to be used as needed. Before signing a check, each of these three is supposed to examine carefully the voucher to be paid, which is always accompanied by the vendor's invoice approved for price, quantity, and extension, the receiving report, and a copy of the purchase order, all properly approved and initialed. Each of the three check signers is very conscious of the importance of internal control and assures you he does examine vouchers very carefully before signing checks.
2. *Cash Sales.* The company maintains a retail outlet for its product adjacent to the office. All sales are for cash. Every sale is rung up by Miss Lober, the sales clerk, on a cash register which ejects a sales slip to be given to the customer with his merchandise. A carbon copy of the sales ticket is made by the machine on a continuous tape locked inside the machine. At the end of each day a "total" key is pressed and the machine prints the total sales for the day on the continuous tape. Miss Lober then unlocks the machine, takes off the total sales figure, makes the entry in the cash receipts book for the day's cash sales, counts the cash in her drawer, retains her basic $30 change fund, and turns the cash received over to the cashier. She then files the cash register tape and is ready for the next day's business.
3. *Purchases.* All goods are ordered by F. B. Wilcox, purchasing agent, upon the request of various department heads. When the goods are received the receiving clerk prepares a receiving report in triplicate; one copy is sent to Wilcox, one copy is forwarded to the department head concerned, and one copy is retained by the receiving clerk. Invoices received are forwarded immediately to the accounting department to insure payment before the discount period elapses. After payment, the invoice is forwarded to Wilcox for comparison with the purchase order and receiving report and is then returned to the accounting department for filing.

Problem 5-3. The Witt Company is engaged in manufacturing. Certain features of its operating methods are described below. You are to consider the procedure for each of the activities as described and point out the existing deficiencies, if any, in internal control, including an explanation of the errors or manipulations which might occur in view of each weakness and your recommendations as to changes in procedures which could be made to correct the weakness.

(*a*) When materials are ordered, a duplicate of the purchase order is sent to the receiving department. When the materials are received, the receiving clerk records the receipt on the copy of the order, which is then sent to the accounting department to support the entry to Accounts Payable and Material Purchases. The materials are then taken to stores where the quantity is entered on the bin records.

(*b*) Time cards of employees are sent to a tabulating machine department which prepares punched cards for use in the preparation of payrolls, payroll checks, and labor cost distribution records. The payroll checks are compared with the payrolls and signed by an official of the company who returns them to the supervisor of the tabulating department for distribution to employees.

(*c*) The company has an employee bond subscription plan under which employees subscribe to bonds and pay in installment by deductions from their salaries. The cashier keeps the supply of unissued bonds in a safe together with the records showing each employee's subscription and payments to date. The amounts of unissued bonds in the hands of the cashier and the balances due from employees are controlled on the general ledger, kept in another department. However, the employees may, if they desire, pay any remaining balance to the cashier and receive their bonds.

When an employee makes a prepayment, the cashier notes the amount on his account, delivers the bond, and receives a receipt from the employee for the amount of the bond. The cashier deposits bond cash received in an employee bond bank account and submits a report showing the transaction to the general ledger department; this report is used as a basis for the necessary adjustments of the control account. Periodic surprise counts of bonds on hand are made by independent employees, who check the amounts of unissued bonds and employees' unpaid balances with the control accounts.

During the cashier's lunch hour or at other times when he is required to be absent from his position, another employee, with keys to the safe in which unissued bonds and employee bond payment records are kept, comes in and carries out the same procedures as enumerated above.

(*d*) A sales branch of the company has an office force consisting of the manager and one assistant. The branch has a local bank account which is used to pay branch expenses. This is in the name of "The Witt Company, Special Account." Checks drawn on the account require the manager's signature and the signature of the treasurer of the company. Bank statements and canceled checks are returned by the bank to the manager, who retains them in his files after making the reconciliation. Reports of disbursements

are prepared by the manager and submitted to the home office on scheduled dates. (AIA)

Problem 5–4. You are invited to address a regional bankers' convention on the subject of internal check in handling loans and discounts. Give an outline of what you would suggest. (AIA)

Problem 5–5. The Dimenslot Company maintains a branch office in a distant city where the only financial transactions authorized are the collection and banking of receipts from automatic vending machines, the payment of branch payrolls and expenses, and the remittance to the factory of funds in excess of branch requirements. Monthly reports of cash receipts and disbursements are sent to the factory.

As auditor, you send to your representative in the branch city twelve monthly reports covering the year under audit with instructions to audit the branch records. In due course you receive a report stating that the monthly reports are in agreement with the books and that the balance in bank has been duly confirmed by the depository. The report also states that the deposits, as shown by the bank statement, exceeded the receipts, and the checks issued by the branch exceeded the disbursements shown by the books. Such excesses consist of items of which a list is enclosed without comments, showing in totals the following disbursements:

Bank loans, partly renewals, finally paid in full	$12,000.00
Checks to employees	2,000.00
Accommodation endorsements for employees	2,088.99

(*a*) What would these three items suggest to you? (*b*) What should be the contra items with respect to each? (*c*) What criticism would you make of your representative's report? (*d*) What further steps, if any, would you take in the matter? (AIA)

Problem 5–6. A corporation decides that the petty cash fund, maintained on the imprest fund system at one of its branches (John Jones, petty cashier), is too large to be kept in the office in cash and proposes to establish the fund in a bank account in the name of the corporation and to authorize the bank to pay checks drawn against the account by John Jones. Give a reasoned opinion of this proposal. (AIA)

Problem 5–7. Describe in not over 100 words for each the meaning of "internal control" and "internal audit." (AIA)

Problem 5–8. Various concerns prefer that bills rendered to them for purchases or services be made out on their own invoice forms. (*a*) What

are the advantages and disadvantages of such a form to the concern? (*b*) How does its use affect the outside auditor? (AIA)

Problem 5–9. What are (*a*) the essential requirements, and (*b*) the principal advantages of an adequate internal control of merchandise inventories? Discuss (*c*) the importance of costing sales in connection with such a control, and (*d*) describe two general methods of costing. (AIA)

Problem 5–10. Give at least four independent statements of principle under each of the three following headings which would guide you in the installation of an adequate system of internal check and control in a fair-sized merchandising concern: (*a*) cash receipts; (*b*) cash disbursements; (*c*) accounts receivable. (AIA)

Problem 5–11. Prepare a questionnaire to be used by assistants on auditing engagements to determine whether or not the clients' systems of internal check are satisfactory with respect to (*a*) loans payable, (*b*) purchases and the relative disbursements. (AIA)

Problem 5–12. State the advantages and disadvantages of the use of a questionnaire in reviewing the system of internal control of a concern which you are examining for the first time. (AIA)

Problem 5–13. Under each of the three following headings, give at least four essential points which should be considered in the installation of an adequate system of internal check and control in a large manufacturing concern: (*a*) inventories; (*b*) payrolls; (*c*) petty cash fund. (AIA)

Problem 5–14. Describe a suitable distribution of duties among the accounting department, the treasurer's department, and any other department to provide adequate protection of disbursements by check. (AIA)

Problem 5–15. For what reason does an independent auditor review a client's internal control, and what two principal questions does he seek to answer in undertaking his review? Compare the extent of his review in the case of the first examination for a new client with that in the case of a client whose records he has examined regularly over a period of years. (AIA)

Problem 5–16. Describe briefly the more important provisions of a system of internal control in connection with accounts receivable. (AIA)

Problem 5–17. Prepare a questionnaire to be used in the evaluation of internal control relating to property, plant, and equipment. (AIA)

Problem 5–18. Prepare a questionnaire for the evaluation of internal control covering cash receipts, for use in your initial annual audit of a large manufacturing company whose sales are made directly to retailers. (AIA)

Problem 5–19. Enumerate five very important items that should be considered by an auditor in the evaluation of the nature and extent of the internal check and control relating to accounts receivable of a merchandising company. (AIA)

Chapter 6

THE AUDIT PROGRAM

Before commencing any verification problem it is well to have prepared an audit program, which is a list of the verification steps to be applied set out in such a way that interrelationships of one procedure to another are clearly shown.

Accounting situations vary considerably from concern to concern and from industry to industry. The nature of the problems to be dealt with, variations in size of the enterprise, and the extent of the internal controls in existence are all factors which must be considered by an auditor in determining what his program will be. In addition, of course, is the extent of his assignment. He may be called on to make a complete examination of the books and records supporting the financial statements of the company or to make only a partial examination aimed at determining the reliability of the cash records, or the fixed property accounts, or any other part of the concern's accounting data. Verification problems thus vary with the accounting situation and with the scope of the audit engagement. Because of such variations, an audit program to specify what work is to be done becomes a necessity in order that time will not be wasted on matters not pertinent to the engagement, and so that any peculiarities of the specific situation may be provided for.

Purposes of an Audit Program. The purposes of an audit program have been suggested in the preceding paragraphs, but it may be well to describe them a little more completely. First, the program serves as a plan of attack on the particular verification problem at hand. It should be remembered that most audit engagements are undertaken by more than one person. The auditor in charge of the engagement commonly has one or more assistants who apply various parts of the verification program under his direction. At the same time he performs certain tests and procedures himself, and therefore he cannot devote his entire time to supervisory efforts. The audit program contains, among other things, his instructions to his assistants. If properly drawn up, therefore, it is complete and detailed enough so that he can turn one or more sections of it over to an assistant, who then proceeds to perform the

verification tasks included therein. Upon completion of the work the assistant returns the program and the work papers prepared during the performance of his work to his superior, who reviews them and either approves or returns them for additional work.

Assistants sometimes have very little experience in actual auditing work. Some are quite unacquainted with practical accounting situations and methods. The program, therefore, must be written in such a way as to tell an inexperienced assistant exactly what is required of him. It is imperative that the accountant in charge and the assistant understand each other. If the accountant in charge wants a certain task performed, he must say so in terms that his assistant can understand, and if the assistant does not feel completely sure of his assignment he must ask for further explanation.

Such expressions as "Check the cash receipts book" have no place in an audit program because they are so indefinite as to have little or no meaning. Rather the program should state specifically what is to be done somewhat as follows: "Foot and cross foot the cash receipts book for the month of December and trace all postings into the general ledger." This latter instruction is clear and definite and the assistant can know when he has completed his assignment. Nowhere in accounting work is clarity and conciseness of expression more important than in the preparation of audit programs.

The second purpose of an audit program is to serve as a record of the work done during the verification process. Such a record is required:

1. As a basis for review by a superior of the work done.
2. As evidence of the extent of the verification.
3. As proof that the work was actually done if such proof ever becomes necessary.

An audit program is prepared with care in view of all the surrounding circumstances. Before the actual verification work begins the program is generally reviewed by a supervisor to assure that all procedures which should have been included are included and that it appears adequate for the purpose. It stands to reason that the supervisor, having spent effort in approving the program, will also be interested in determining that the program as established was actually followed. Consequently, he will wish to review the work done to make certain that all steps provided for in the program were either carried out or that adequate explanation for their omission is presented.

Auditors work with the books and records of an accounting department. When they complete their work they must leave all the books and records in the hands of that accounting department. Accordingly, they have as evidence of their own work only such work papers as they have prepared during the course of their verification. One of the most important work papers, from the point of view of indicating exactly what work has been done, is the audit program itself. It becomes a part of the work papers and if properly initialed by the various members of the audit team as they complete the verification steps described it becomes a valuable record not only of the extent of the planned verification but of the actual work done. Many audit programs are drawn up in such a way that this record is easily incorporated into the work papers as follows:

Verification Procedure	Date or Period Covered	Work Done by	Date Completed

In rare cases a question arises as to whether all work which should have been done during an audit engagement was actually completed and as to whether or not the verification was adequate in view of the requirements of the situation. When this happens it becomes necessary for the auditor to prove what his verification was and to convince a court, if necessary, that the program followed was adequate. When this occurs it becomes extremely important to have an audit program that is complete and that is supported by a satisfactory set of work papers. A carefully prepared program initialed by the staff auditors as the work was completed would be included as some of the best evidence an auditor could present in or out of court to substantiate his claim of a satisfactory examination.

Program Construction. In the preceding chapters the nature of an audit engagement as a matter of collecting evidence to determine the reliability of the accounting data of a company has been explained. Along with that a discussion of the nature and possibilities of errors in accounting data has been included as well as a description of the basic audit or verification techniques available to an auditor. Program construction consists of selecting and putting together the specific audit techniques to be used in a given case. In so doing an auditor must give consideration to a variety of factors. He must:

1. Stay within the scope and limitations of his assignment.
2. Obtain the best evidence reasonably possible.

3. Apply only those tests and procedures which are useful to accomplishing the verification purpose in that specific situation.
4. Cover every possibility of error to some extent.
5. Group related items.

Effect of Audit Assignment. Whether serving as an independent public accountant or as an internal auditor, an auditor can do no more than he is permitted to do by the terms of his assignment. Very few audits are required by law, and in general legal requirements only make necessary that which business practice would have called for anyway. In the United States, auditing has developed strictly upon the basis of the service which it has rendered to the business community, and for all practical purposes will continue to develop only as it continues to render needed service.

The scope of the engagement therefore is a matter of agreement between the auditor and the company whose records are to be examined. The agreement may call for anything from a detailed verification of every transaction (extremely rare) to a review of a limited number of transactions of a given type. Whatever that agreement calls for, the auditor must confine himself to that task, not only to refrain from inquiring into matters which are not his concern but also in order to do the best job possible within the time allotted. On an audit engagement, time and cost run very closely together. Any unnecessary work takes additional time, which means additional cost; therefore, it must take time away from the real purpose of the engagement. If, for example, there is suspicion of fraud in the cash transactions and an auditor is retained to investigate all cash transactions and the recording thereof, he would be wasting time to examine into the appropriate classification of fixed asset items. Any time spent on such an irrelevant subject as this could not be spent on matters pertinent to the agreement and would therefore be wasted. So, in selecting the tests to be combined into an audit program, one must be careful to use only those which are pertinent to the audit purpose and included within the scope of the engagement.

Obtain Best Evidence Possible. In Chapter 3 the value of the evidence obtained by application of the various verification techniques is discussed. It was seen that certain techniques provide satisfactory evidence, whereas others by themselves are inconclusive. An auditor must be fully aware of this, and in selecting the procedures to be applied should attempt to get the best evidence possible in every case. If the

procedures applicable in the given case do not provide completely reliable evidence he must supplement the results with other tests until he is satisfied that he has exhausted the reasonable possibilities or until he is certain that the facts are as stated. A note payable to a bank can be verified by obtaining a statement from the bank as to the amount of the note, its due date, interest rate, and all other essential features. This is strong evidence and can be relied on. On the other hand, a damage suit against the company under examination and still in process of litigation is a far different matter. The amount that should be recorded as a liability for such a suit is difficult to obtain. An auditor should correspond with the company's attorneys to obtain their considered estimate of the potential liability, should discuss the matter with the company's officers, should examine any correspondence accumulated on the subject, and if the company has had experience with this type of litigation in the past should investigate the results of similar cases already decided. Only after getting all available evidence, any one part of which is probably inconclusive, can he feel that he has the best evidence available on the subject.

Selecting from among available alternative procedures is largely a matter of judging the reliability of the evidence which they will produce. Because of considerations of time and of cost it is not always possible to select the best one, but if anything less than the best possibility is selected it must be one that either provides satisfactory evidence itself or that can be supplemented by other techniques until it does.

Use Procedures Applicable in the Circumstances. The most difficult part of program development is in adapting what may be termed general procedures to the requirements of a specific situation. Every auditor soon comes to know, for example, the basic requirements for the verification of cash on hand. To apply those requirements in the variety of situations found in practice is a far more difficult task. One concern may have only a single bank account, so that the problem is relatively simple. Another may have several bank accounts at the home office plus a score or more of branches each with its own bank accounts. Then too, there may be frequent transfers of cash from one account to another, which further complicate the verification problem. As another example, one company may sell on account, so that its cash receipts record consists of a list of the checks received through the mail from its customers. Another may sell only for cash, so that its basic record of cash receipts consists of adding machine tapes from cash registers.

The audit program for each of these companies must provide for the specific records and problems of that company.

This indicates that program preparation relies heavily on the review of internal control. Preliminary to completing the program, if not to beginning it, the auditor must know what records the company maintains, who maintains them, and what controls are in existence to eliminate or reduce the possibilities of error. The review of internal control and the construction of the audit program go hand in hand and must be closely related.

Part of program construction is to determine the extent to which various tests and procedures should be applied. Should the cash disbursements book be footed for twelve months, for six months, or for one month? Should canceled checks be compared with the entries in the check register for three months or for seven months? These are questions which only an experienced auditor is expected to answer, but again he can answer them only if he has a thorough understanding of the internal controls in existence and the extent to which they are effective in reducing the possibilities of error. A good system of internal control rarely makes any given test completely unnecessary, although it may reduce the application of the test to the minimum. In general the minimum application is a single month because a month is required to complete the bookkeeping cycle and because by applying any test throughout a complete bookkeeping cycle one can determine whether or not the internal control procedures supposedly in force are actually being applied effectively.

Cover All Possibilities of Error. If properly constructed, an audit program will provide procedures aimed at detecting any errors that fall within the scope of the examination agreement. This requires a sound knowledge of types and possibilities of error plus considerable skill in weaving together the various audit steps. The program must not only cover all possibilities for error but also must integrate the procedures in such a way as to reduce duplication and conflicting efforts to the minimum. This is covered more completely in the following section but is also applicable here.

An auditor commonly begins his work with the general ledger balances. Therefore, in building up his techniques he is most likely to cover all possibilities if he begins with the general ledger balance and works back to the source of the data summarized in that balance figure. This process falls into three categories of work:

1. Verification of the balance.
2. Tracing the source of entries in the account.
3. Verification of the basic transactions.

The emphasis on one or the other of these parts of the verification problem varies with the nature of the account to be verified. In verifying cash, considerable effort is spent in determining that the cash on hand actually agrees with the amount of cash shown as the balance of the account, as that figure is of considerable importance in the balance sheet. Relatively less attention is given to the specific transactions which go to make up the cash balance because there are so many of them, because they generally are subject to careful internal control, and because many of them, especially cash receipts, are extremely difficult of direct verification. In verifying fixed assets less attention is given to verifying the balance and far more attention, relatively, is given to the individual transactions which go to make up the balance. It is difficult to prove the balance of the fixed asset accounts by comparison with the actual asset itself as is done for cash, so the general practice is to verify the various transactions which go to make up the balance and to assume that if they are correctly handled the balance must be correct. Other variations exist in the relative emphasis given to these areas of verification, but in every case each one of them gets a certain amount of attention.

In verifying the balance of an account it is common practice to prove the arithmetical accuracy of the figure by footing both sides of the account and then recomputing the balance. If possible, recourse is had to the actual asset to determine by physical examination if the quantity is in agreement with the account balance, but this is not practical for liability accounts and for such asset accounts as Accounts Receivable. It is extremely desirable for notes receivable, investments, inventories, and cash and such other assets as can be readily identified, counted, and priced.

In verifying the source of the entries in the account, first attention should be given to scanning the ledger account to see whether the entries therein appear to come from appropriate sources. Those which appear unusual or out of order should be traced back to their source and documentary evidence examined to determine if the transaction was legitimate and the entry appropriate. The composition of the account balance likewise should be analyzed to ascertain whether it includes any amounts which are not genuine or any items or amounts which should perhaps be classified under some other heading. If possible, the actual

items which the account represents (cash, notes receivable, merchandise) should be counted and agreed with the ledger account balance. This last step is often difficult but if possible and practicable should be attempted.

In verifying the source of entries, all debits and credits to the account, or all material debits and credits if there are frequent minor entries, should be traced back to their source to assure that no errors have been made in the posting process. In some cases this, like many other verification procedures, is applied on a test basis and only the entries for one or more months are traced back to their source. In either case the test should be applied with care as any amount brought forward in error results in an incorrect balance.

Care should be exercised to make sure that entries are traced all the way back to their source. Many companies summarize the detail of transactions at least once before they are entered into the general ledger accounts. For example, a company may summarize all cash sales each day for a single daily entry in the cash receipts book. Then at the end of the month, the totals of the cash receipts book are posted to the general ledger. In tracing such entries back from the general ledger it is not sufficient to trace them only to the cash receipts book. The cash receipts book is merely an intermediate step, and the tracing must go beyond it back to the original memoranda of receipt, whatever form they may take. The totaling necessary to arrive at the daily summary entry in the cash receipts book must be proved as well before one can say that he has actually traced the entries in the general ledger accounts back to their original source.

Once the entries have been traced back to their original source, it becomes possible to verify the transactions that the entries purport to represent. This is largely a matter of referring to such documentary evidence of the transaction as may exist, duplicate sales invoices, canceled checks, shipping tickets, expense vouchers, invoices, remittance advices, and the like. This, of course, is one of the basic verification techniques and is discussed in some detail in Chapter 3. Verification of the transactions themselves is fundamental to understanding the nature of an account balance. No matter what the description of the account or its title may be, one can never truly know what actually makes up the balance until he has examined into the nature of the transactions which have been entered in the account. A generous portion of transaction verification by reference to documentary evidence thus becomes an important, although sometimes tedious, part of every audit program.

It should be evident that in some instances the intermediate step of tracing entries back to their source can be combined with that of examining documentary evidence. Under some voucher system installations the general ledger account includes the voucher number of every entry, and thus it is possible to refer from the ledger account directly to the appropriate voucher which includes the invoices, receiving reports, and other evidence of propriety. In other cases, however, it is necessary to work from the ledger account back to the book of original entry to obtain the detail of the entries into the account and thus locate the specific vouchers and invoices.

In working out his audit program, the auditor must follow mentally all entries in general ledger accounts back to their source and determine those points at which errors are possible and are most likely to occur. Then in selecting the specific procedures to be included he must make certain to cover all such possibilities to the extent he feels is necessary.

Group Related Items. Finally, in assembling the procedures which he has concluded are necessary to accomplish his task of verification, an auditor should group those procedures in the most natural manner possible. This particular problem is most apparent when one has a complete audit program to construct rather than a brief investigation or a partial audit. In the latter, the program may be so brief as to make any grouping of related procedures within the program impossible.

As an example of what is intended here, a relationship which has already been mentioned may be cited once again. One common type of error is a failure to distinguish correctly between asset and expense items, between additions to fixed assets and repair and maintenance charges. Therefore, to verify these two groups of accounts, it is necessary to analyze the asset accounts to make certain that no expense items have been included and to search the related expense accounts for any items which should have been charged to the fixed asset accounts. Because of this close interrelationship of the two groups of accounts it seems logical to assign them both to the same member of the audit staff or at least to deal with one in conjunction with the other.

Further consideration of this matter indicates that depreciation is so closely related to the fixed asset accounts that depreciation expense and the reserve for depreciation should likewise be considered together with the fixed asset accounts. Thus we have what may be called the property or fixed asset group consisting of the fixed asset accounts, related repair and maintenance accounts, the reserve for depreciation accounts, and the related depreciation expense accounts.

In like manner, Notes Receivable and Interest Income are related, and also Notes Payable and Interest Expense. Prepaid Insurance may be verified in connection with Insurance Expense, and Accrued Taxes can be related to Taxes Expense. Investments, Income from Investments, Gains or Losses from the Sale of Investments, and any necessary adjustment to the lower of cost or market also constitute a group of related accounts which for verification purposes should be attacked together. Other natural groupings exist and are discussed throughout this textbook.

Another type of grouping of audit procedures within the audit program also warrants at least passing mention. There must be included within the audit program a considerable amount of detail work such as footing, tracing postings, and comparison of original documents with the books of original entry. This so-called "detail" or "general" audit work is often grouped by itself in the audit program and assigned to one of the assistants. Assignment of all such work to one man is more in the nature of a matter of convenience than of grouping truly related items. That is, no harm would result from dividing such work among a number of persons, whereas separating the work on Notes Payable from that on Interest Expense might actually have a detrimental effect on the verification accomplished.

Types of Audit Programs. Various mechanical means are used by auditors to assist them in program construction. Some auditors make use of "uniform work papers," which include on the reverse side what amounts to standard verification programs for the principal accounts or groups of accounts. Others have preprinted programs covering special sections of the work such as that on cash, cash transactions, and the detailed or general work. Obviously, such preestablished programs require modification to make them applicable to specific situations. Because of this, other auditors use no established programs but instead draft their own program for each situation as they meet it, relying on their own knowledge of auditing techniques and their past experience to insure that all essential procedures have been included. Still others draft their own programs but carry a more or less extensive "check list" of auditing procedures from which they select those which they think are most applicable.

The method of preparing the audit program is important only in so far as it affects the verification actually accomplished. One can very soon learn to work with any one of these various methods, and if he is

alert and well grounded in the fundamentals of an audit attitude can develop adequate programs.

The next several chapters are aimed at developing further the ability on the part of the student to prepare audit programs and to carry them to completion. An attempt has been made to build this development around the natural account groups as it is believed that a recognition of these relationships is an essential to sound program planning. A word of warning is necessary at this point. The programs developed within each chapter may have the appearance of being uniform or standard audit programs for that specific subject. Such is not the case. The writer has little faith in standard programs in auditing and wishes to disclaim any intention of developing them. Rather these programs should be looked upon as something of a minimum verification requirement which in the individual case must be accomplished as indicated by the accounting records and procedures in existence. Thus they will require some modification in every case and serious modification in many. At the same time they provide a reasonable theme around which to discuss the details of audit procedure.

PROBLEMS—CHAPTER 6

Problem 6–1. Describe what you consider to be (*a*) the best, and (*b*) supplementary evidence for each of the following account balances: 1. Miscellaneous Office Expense. 2. Notes Receivable. 3. Notes Payable. 4. Land. 5. Petty Cash. 6. Marketable Securities. 7. Treasury Stock. 8. Earned Surplus. 9. Accrued Interest Payable. 10. Finished Goods Inventory.

Problem 6–2. In what way would the verification of Accounts Receivable differ in the following situations? 1. A department store selling on terms of thirty days. 2. A small loan company. 3. A company manufacturing military equipment for the government.

Problem 6–3. The L. and M. chain grocery sells only for cash in huge "supermarket" type stores. Several cashiers are required in each store, each operating a separate cash register. If you were assigned to verify the balance of the Sales account, what various documents or records would you call for as evidence? How would you use them?

Problem 6–4. What other accounts would you wish to examine in connection with each of the following balances: 1. Accounts Receivable. 2. Interest Expense. 3. Reserve for Sinking Fund. 4. Patents. 5. Marketable Securities.

Problem 6–5. Assume that one of your close relatives owns a men's clothing store in a community of about 60,000 people. As he is very busy with other business affairs he employs a manager to operate the store on a salary plus a bonus based on profits arrangement. During the Christmas holidays he asks you to "go over and have a look at the books to make sure everything is all right." (*a*) Outline the general program you would follow. (*b*) What are some of the special problems you would expect to find? (*c*) What would be the starting point for your examination?

Problem 6–6. In what way would the audit programs for the following types of business be similar? In what way would they be different? 1. A grain elevator. 2. A wholesale druggist's supply company. 3. A large restaurant. 4. A building and loan association. 5. A lumber yard. 6. A bakery. 7. A shoe store.

Problem 6–7. What steps would you suggest as appropriate in each of the following situations? 1. To determine that all cash has been accounted for by the cashier of a neighborhood movie. 2. To determine that all cash has been accounted for by a city in connection with the proceeds from parking meters. 3. To determine that all cash has been accounted for by an agent

who services a large number of candy vending machines, refilling them when empty and collecting all cash from sales.

Problem 6–8. What records would you call for and how would you use them if you were assigned to audit a campus book store?

Problem 6–9. What steps would you take to assure that salesmen assigned to delivery routes for a dairy company accounted for all products they took from the plant each day?

Problem 6–10. How would you verify the payroll disbursements of a highway construction company?

Problem 6–11. What steps would you take to verify the inventory of a wholesale distributing company?

Problem 6–12. With what accounts would you be particularly concerned in each of the following audit examinations? 1. A small loan company. 2. A jewelry store. 3. A real estate agency. 4. A stock brokerage firm. 5. A hospital.

Chapter 7

VERIFICATION OF CASH AND CASH TRANSACTIONS

Cash provides at once one of the most difficult and one of the most interesting verification problems with which an auditor must deal. It is difficult because cash enters into so many transactions that in most cases all an auditor can do is to test a small portion of the total cash transactions. It is interesting because of the appeal which cash has to the acquisitive instincts of people in general and because by far the great majority of irregularities have to do with cash in one way or another. Therefore, in planning the cash verification program, extreme care must be taken to provide that the tests planned are adequate in extent and that they cover all possibilities of error. In performing the tests provided in the program, care is also required both because the work is based upon tests and samples and because of the always present danger of shortages or manipulations.

Twofold Purpose of Cash Verification. In planning and performing the cash work, as with any part of the audit program, the verification purpose should be kept firmly in mind. This is always necessary so that if at any time the procedures being followed do not appear to accomplish the desired objective they can be altered or modified as necessary.

The purpose of cash verification may be described briefly as:

1. To ascertain if all cash is there that is said to be there.
2. To ascertain if all cash is there that should be there.

These two sound somewhat alike but actually they are quite different. If the balance of the general ledger Cash account on the balance sheet date indicates that the company has $20,000 in cash, the first part of the audit work pertaining to cash is to determine whether the company does actually have cash in the amount of $20,000. But an auditor should go beyond that. He is interested not only in whether the company has as much cash as the records indicate it has but also in whether the records state the company has as much cash as it actually should

have. In other words, from the transactions into which the concern has entered during the year, a balance of $25,000 perhaps should be on hand. In such a case it is not enough for an auditor to find out that the company does actually have the $20,000 the records indicate; he must also find what happened to the additional $5,000 which is not shown by the records.

Of course, these two purposes are closely related. Yet they are still separable and can be accomplished separately. The first is always an important objective in any general audit. The second is frequently neglected in some degree. Actually, both should be given careful attention and an auditor has not completed his mission of cash verification until he has an answer to both problems.

Importance of Review of Internal Control. The approach to the verification of cash and of cash transactions is through the review of internal control. There are certain minimum procedures and tests to be applied which will be performed in any case. However, not until there has been a thorough review of the internal controls actually in use and not until the records and accounting procedures are well understood by the auditor can he work out in detail the program to be followed.

If, for example, one person has complete control over cash disbursements, including approval of invoices for payment, writing and signing checks, mailing checks to creditors, and reconciling the bank statement, the possibilities for error, intentional or unintentional, are much greater than they would be if those duties were all separated or carefully reviewed by a superior. Here the extent of the verification procedures necessary to satisfy an auditor that all was well would be much greater than in a situation where such duties were subdivided among several people each of whom acted independently of the others.

Likewise, the nature of the records kept is of considerable importance in planning the detailed verification work, and until the auditor planning the program knows precisely what those records are his instructions to his assistants cannot be as clear and specific as they should be.

Basic Requirements of Cash Verification. If the objectives discussed previously are to be achieved, the auditor must satisfy himself as to the following:

1. What the balance of cash actually is.
2. What the records show the balance of cash should be.
3. Whether transactions have been properly recorded.

Of these three, the first and third are the most difficult, as the second can be found readily by reference to the balances of the various cash accounts. All three are important, however, and should be kept in mind in studying the detailed program that follows.

Any failure of cash actually on hand to agree with the records indicates an error either in the cash on hand or in the records themselves or perhaps in both. Any failure of transactions to be recorded properly indicates an error in the recorded balance of cash. Thus it is possible to have a situation where the cash on hand agrees with the recorded balance of cash but because the latter is in error the apparent agreement is not satisfactory at all. Likewise there may be a discrepancy between the actual cash and the general ledger balance and in turn the general ledger balance may be in error so that two quite distinct and separate errors must be considered together to determine what the total error is. Both possibilities must be kept in mind.

Essentials of Verification Program. As a basis for discussing the detailed verification procedures for cash and cash transactions, an outline of the essential steps will be presented. From the outline it will be evident that certain steps are in the nature of supplementary procedures to support more basic steps. It is also possible to see in what manner the basic procedures tie in with the twofold verification objective.

1. To ascertain that all cash is there that is said to be there.
   A. Count cash on hand.
      1. Count all cash on hand simultaneously.
      2. Count it in presence of custodian and obtain receipt.
      3. Include in work papers adequate detail of items counted to permit subsequent investigation of peculiar items.
      4. Control any undeposited receipts until they are deposited in the bank and obtain duplicate copy of bank deposit ticket.
      5. Investigate by such means as seem satisfactory any unusual items included in cash submitted for count.

   B. Determine cash in bank by reconciliation with bank statement.
      1. Prepare own bank reconciliation or, if client has already prepared a reconciliation, review his thoroughly.
         (*a*) Determine outstanding checks from a comparison of canceled checks returned by bank with checks recorded as issued in check register. For checks outstanding since the beginning of the period under examination it is neces-

sary to refer to the bank reconciliation in the work papers for the preceding audit.

(*b*) Determine deposits in transit from comparison of cash receipts book with deposits shown on bank statement.

(*c*) Investigate any other reconciling items until satisfied as to their validity.

2. Obtain a confirmation from the bank as to the balance per bank on the reconciliation date.
3. Obtain a "cut-off" bank statement direct from the bank.

(*a*) Verify outstanding checks by comparison of canceled checks accompanying cut-off statement with list of outstanding checks on reconciliation date.

(*b*) Verify deposits in transit by tracing them into deposits listed on cut-off statement.

(*c*) Review all checks returned with cut-off statement for unusual items and for checks not recorded at reconciliation date.

C. Agree cash balances determined by count and reconciliation with cash balances per general ledger.

D. Clear all noncash items from the Cash account balances by adjusting journal entry.

2. To ascertain that all cash is there that should be there.

A. Foot cash books (including cross footings).

B. Trace postings into general ledger.

C. Foot and balance Cash account.

D. Investigate any peculiar entries in Cash account.

E. Examine documentary evidence of entries in cash records.

F. Scan cash discounts for propriety.

G. Review bank reconciliations made during the year.

H. Reconcile receipts per books with deposits per bank and disbursements per books with checks paid per bank.

I. Compare detail of duplicate deposit tickets with detail of cash receipts record.

J. Account for all check numbers.

K. Examine any outstanding checks at previous audit date which did not clear with cut-off bank statement obtained at that time.

Each of these several steps has a particular verification function to perform, and omission of any one is likely to decrease the efficiency of the overall program seriously. Needless to say, careless performance

of any verification step is at least as detrimental to the outcome of the examination as complete omission.

The following paragraphs expand somewhat on the methods to be followed and the important points to be watched in the performance of these several procedures.

Count Cash on Hand. Cash on hand commonly consists of two different types, cash funds and undeposited receipts. The contents of various change and imprest or other petty cash funds are relatively easy to count and verify because the fund total is fixed and the amount determined by count can be readily checked against the ledger account balance. In many cases, cash receipts from the day's cash sales or from customers' remittances may also be on hand because they have not yet been deposited in the bank. Such cash also must be counted and, further, must be controlled until deposited, as discussed later in this section.

The importance of simultaneous count of cash on hand cannot be overstressed. Assume an office with three substantial change or petty cash funds. Fund *A* is counted and totals to \$500 as it should; fund *B* is then counted and it too totals to \$500 as it should; fund *C* is then counted and again it totals to \$500 as it should. But if there has been any opportunity for amounts from one fund to be transferred to another while the count was in process, it is entirely possible that not \$1,500 but something less than that amount is actually on hand and the shortage has been covered by transferring amounts from one fund to another temporarily so that the count would not find any of them short. Unless the possibility for substitution from one fund to another is eliminated, cash counts, no matter how carefully made in other respects, cannot be relied on.

Transferring cash from one fund to another is but one of the many possibilities. Undeposited receipts may be used to cover a shortage in a fund; investments or securities may be pledged temporarily to obtain funds that are then used to cover a shortage; amounts may be withdrawn from bank accounts by means of unrecorded checks to fill in for cash that should be on hand and is not.

This points out that all cash on hand must be counted simultaneously with counts of securities, and that care must be taken to assure that no amounts of cash in bank have been withdrawn to cover shortages of cash on hand.

Sometimes it is extremely difficult to achieve a simultaneous count of all cash on hand. Where there are several imprest or working funds, or

where funds are widely separated physically, or where the funds are under the control of different custodians who work different shifts, it becomes a real problem for the auditor to count them all at the same time. This is especially true if he is alone on the job or has but one assistant. But simultaneous count does not mean that all must be counted at the same time. It merely means that they should be counted in such a way that substitution from one to another is impossible. By careful planning, this can usually be worked out. One possibility is to seal by means of a gummed paper sticker those funds that cannot be controlled in any other way and not to permit access to them until they have been counted. When such funds must be used continuously for operating purposes it may be necessary to count them during hours when the store or office is closed, or perhaps to count out small working funds in advance and require that they suffice until the regular funds have been counted.

Cash counts are important and sometimes present difficulties. The problem should be investigated well in advance of the date selected for the actual counts, and arrangements should be made so that in so far as possible the work will go smoothly and efficiently and cause minimum interference with the work of those responsible for the cash.

One important practice which is sometimes disregarded is that of counting each fund in the presence of the custodian of that fund. In every case someone is responsible for cash funds. When counting any amount of cash, or of securities either, it is well to insist that the person responsible be present. This is desirable so that any shortages or other errors are discovered in the presence of the person most concerned. To illustrate the dangers in neglecting this precaution, assume an auditor finds a shortage while counting a petty cash fund during the temporary absence of the custodian from the scene of the cash count. Certainly it would cause strained relations, at least, if the custodian should claim innocence of the shortage, especially since the auditor might be a stranger in that particular office whereas the fund custodian might be an old and trusted employee.

It is generally possible, with little difficulty, to impress upon those whose funds are being counted that they are requested to be on hand throughout the count and that, if they desire to leave, the funds should be locked up and the count postponed until they return.

Another sound practice is to obtain a receipt from the custodian for the return of the funds to him. This can be done in a variety of ways, the simplest of which is probably to write across the bottom of the work

Clement Company
Petty Cash
12/31/54

RLM
1/2/55

Counted 8 00 AM 1/2/55

Bills				
$10 00	3		30 00	
5.00	4		20 00	
1 00	18		18 00	
Roll coin				
Halves	1 @	$10.00	10 00	
Quarters	2 @	10 00	20 00	
Dimes	1 @	5.00	5 00	
nickels	1 @	2 00	2 00	
Coin loose				
Halves	7		3 50	
Quarters	24		6 00	
Dimes	15		1 50	
nickels	16		80	
Pennies	29		29	
Total coin and currency				111 09
Checks				
C T. Young 12/28/54 payable to "cash"				35 00 ✕
Total cash items				152 09
Vouchers				
Anderson's Stationery Shop 12/21/54	Paper		18 65 ɴ	
Stevenson's Supply Store 12/26/53	Janitor supplies		19 23 ɴ	
Railway Express 12/24/53	Express		10 03 ɴ	47 91
Total per count and per books				200 00
Less non-cash items A J E #1				47 91
Balance per audit 12/31/54				152 09

This fund was counted in my presence by a representative of Test and Prove and was returned to me intact

F.E Hoedgers

ɴ Vouchers examined - apparently in order.
✕ Check approved for cashing by Scott Edwards, office manager

Illustration 8. Work sheet for count of petty cash.

sheet upon which the count was made a brief statement as follows: "This fund was counted in my presence by a representative of (*name of accounting firm or department*) and returned to me intact"; and then to request that the custodian sign the statement. This is then proof that the fund was counted, that the custodian was present during the count, and that the full amount of the count, as shown on the work sheet, was returned to the custodian.

In making the count a work sheet should be prepared to record all important details. This should include the name of the fund, the name of the custodian, and the date and time of the count, as well as the composition of the fund.

If an imprest or other petty cash fund is counted at any time other than immediately after reimbursement, a variety of items may be found included in it; petty cash vouchers for expenditures made and not yet reimbursed, checks cashed as a convenience for customers or employees, I.O.U.'s, stamps, and other such items may be present. In making the count, which usually should be done quickly so that the fund can be released and the custodian permitted to return to his duties, it may be impracticable to investigate many of these items as completely as desirable. Therefore the work sheet recording the count should be prepared with sufficient information about each component of the fund to permit later investigation to the extent considered necessary. Thus the count may consist of two parts: (*a*) the listing of the components of the fund, (*b*) investigation of any unusual items.

Undeposited receipts are always something of a problem because they offer such an opportunity of substitution for shortages in other fixed funds. The amount of cash received from customers and not yet deposited is not fixed, and therefore abstraction of some of this cash to cover a shortage elsewhere is less likely to be discovered than if cash is taken from some other fund which has a fixed amount. For this reason undeposited receipts must be carefully controlled by the auditor from the time he counts them until they have been deposited in a bank or other financial institution. Upon completion of the count, the cashier or other person responsible should be asked to prepare a bank deposit of the receipts on hand with a duplicate deposit ticket prepared for the auditor. Then, still under supervision of the auditor or his assistants, the deposit should be taken to the bank and the duplicate deposit ticket initialed by the bank cashier. It then becomes a part of the audit work papers.

To insure that no amounts were taken from the undeposited receipts before they were counted and deposited, the auditor should compare the detail of his count with the deposit ticket and with whatever record of cash receipts the company has. Any recorded cash receipts not included in the deposit suggest that those funds have been used to cover a shortage somewhere else, and a satisfactory explanation by the custodian is required.

Shortages within a fund can be covered temporarily by means other than cash borrowed from another fund. If a fund custodian is short

and if company practice permits him to cash checks for others, he can readily prepare a check and insert that into the fund to cover his shortage. If the company permits temporary borrowing by employees he can use an I.O.U. to replace any missing funds. Forged petty cash vouchers may be placed in the fund so that it will appear as if the missing cash was expended for company purposes, and in some cases actual vouchers already reimbursed may be altered as to date and used again. Because of these and other possibilities, anything in a fund other than cash must be carefully scrutinized by the auditor and must not be accepted until he is satisfied it is genuine.

Vouchers must be carefully examined so that unauthorized or non-company expenditures may be discovered and brought to the attention of the custodian's supervisors. If the internal control over petty cash disbursements does not provide for the mutilation of vouchers on reimbursement, special care to insure that dates have not been altered or vouchers used over again must be taken.

Checks included in a petty cash fund may or may not be legitimate. The company attitude toward the cashing of checks for employees and others should be ascertained during the review of internal control. Any breach of company rules should be noted in the work papers and brought to the attention of the appropriate company officials by the auditor in charge. If there is any question whether checks in the fund are legitimate, the auditor can request that they be turned over to the general cashier for reimbursement and that the general cashier deposit them in the company bank account. If such checks are not good they will be returned by the bank. So that their return will be brought to his attention, the auditor should make arrangements through the company's officials to have the bank notify him directly of any returned items for a period of several days after the deposit.

I.O.U.'s in the fund are never acceptable as cash and must be cleared by journal entry if at all substantial in amount. However, there is always a chance that they have been introduced to cover a shortage so the approval of someone other than the custodian must be obtained to indicate that the loan transaction was legitimate and within the scope of the custodian's responsibility and authority.

Once the cash on hand has been determined by count and all unusual items have been investigated, the amount so arrived at should be compared with the fund balance as indicated by the general ledger account. This is the final and essential step required to point out any existing shortage. If a shortage does exist it must, of course, be recorded and the ledger account balance reduced accordingly by journal entry.

In some cases petty cash funds are not maintained on an imprest basis. That is, minor items of cash receipts are added to the fund and disbursements made therefrom. This makes control over the fund extremely difficult and makes verification of the fund balance and fund transactions difficult also. The amount on hand must be reconciled to the recorded amount of the Cash account, and then the transactions building up the balance must be traced to discover whether the recorded balance is correct. Where receipts from such sources as vending machine commissions, scrap sales, and the like are included, absolute proof of the balance becomes impracticable. In such cases an auditor must recommend that changes be made in the handling of the fund and then proceed to such verification as his time permits and the materiality of the amounts involved requires.

Determine Cash in Bank by Reconciliation. Cash on deposit with a bank or other financial institution cannot be verified by examining and counting it as is done with cash on hand. A substitute method is employed which, basically, is to obtain a statement from the bank as to the amount on hand. Most banks send their commercial customers monthly statements of the amount of cash remaining on deposit at the end of the month as well as a detailed record of all transactions during the month. This record, of course, is the bank statement, which becomes a part of the documentary evidence supporting the accounting records of the business under examination.

To prove the bank's figures as well as its own, the accounting department prepares a bank reconciliation to account for any difference between the bank's record of the company's cash on deposit and its own record of cash in the bank. To the company, then, a bank reconciliation is a means of checking its own and the bank's record of its cash on deposit. An auditor prepares a bank reconciliation in about the same way but for a somewhat different purpose. He is interested in learning whether the company does actually have cash on deposit in the amount which it claims. He prepares a bank reconciliation, therefore, in lieu of actually counting the cash. To him it is evidence of the existence of the cash in the bank.

Frequently the company will have its bank reconciliation all prepared by the time the auditor begins his cash work. That is, if an auditor some time in January is verifying the cash on deposit as of December 31, he may find that the company has already received its bank statement with the paid checks and has prepared its reconciliation at that date. Rather than getting the bank statement and checks directly from the

Clement Company
Bank Reconciliation
12/31/54

RLM 2-7-55

Balance per bank statement			2789431 c
Less outstanding checks			
# 3894	6/12/53	1580 r	
3894	6/28/53	7315 r	
4317	12/27/53	18650 n	
4319	12/27/53	83112 n	
4324	12/31/53	71011 n	
3325	12/31/53	19888 n	
4326	12/31/53	46785 n	
4327	12/31/53	81219 n	329560
			2459871
Add deposits in transit			
12/30/54		115280 x	
12/31/54		62576 x	177856
Add bank debits			
December service charge		1850 4	
Interest on note payable		30000 4	31850
Balance per general ledger			2669577
Less audit adjustments			
A J E (3) to record December service charge and interest on note			31850
Balance per audit 12/31/54			2637727

c Confirmation attached
n Returned with 1/15/55 bank statement - appear proper
x Credited 1/2/55 by bank per bank statement
4 Bank debit memos examined
r Recommended company stop payment and return to cash

Illustration 9. Bank reconciliation.

bank with the assurance that no one has tampered with them, he must accept them as given to him by the company's employees after they have had ample opportunity to make any changes they found desirable. This means that additional care is required on the part of the auditor in such situations. If he can obtain the checks directly from the bank and prepare the reconciliation himself he has an advantage that is lost if the reconciliation has already been prepared. It is not, however, a matter

STANDARD BANK CONFIRMATION FORM - 1953

Approved 1953 by
AMERICAN INSTITUTE OF ACCOUNTANTS
NATIONAL ASSOCIATION OF BANK AUDITORS
AND COMPTROLLERS

ORIGINAL
To be retained by Bank

______________19____

Dear Sirs:

Your completion of the following report will be sincerely appreciated. If the answer to any item is "none", please so state. Kindly mail it in the enclosed stamped, addressed envelope direct to the accountant named below.

Report from

(Bank)______________________________

____

____

Name of accountant

Yours truly,

____

By______________________________
Authorized Signature

Bank customer should check here if confirmation of bank balances only (item 1) is desired ☐

Bank should check whichever is applicable
This report covers all accounts
1 with this office ☐ or
2 with this office and all other domestic offices ☐

Dear Sirs:

1. We hereby report that at the close of business on______________19____our records showed the following balance(s) to the credit of______________________________

AMOUNT	DESIGNATION OF ACCOUNT	REMARKS: IS BALANCE SUBJECT TO WITHDRAWAL BY CHECK?	REMARKS: DOES ACCOUNT BEAR INTEREST? GIVE RATE
$			

2. We further report that the above mentioned depositor was directly liable to us in respect of loans, acceptances, etc., at the close of business on that date in the total amount of $__________, as follows:

AMOUNT	DATE OF LOAN OR DISCOUNT	DUE DATE	INTEREST		DESCRIPTION OF LIABILITY, COLLATERAL, LIENS, ENDORSERS, ETC
			RATE	PAID TO	
$					

3. Said depositor was contingently liable as endorser of notes discounted and/or as guarantor at the close of business on that date in the total amount of $__________, as below:

AMOUNT	NAME OF MAKER	DATE OF NOTE	DUE DATE	REMARKS
$				

4. Other direct or contingent liabilities, open letters of credit, and relative collateral, were

Yours truly,

(Bank)____________________

Date________________19____ By____________________

Authorized Signature

If the space provided is inadequate, please enter totals hereon and attach a statement giving full details as called for by the above columnar headings

Illustration 10. Bank confirmation form.

of basic importance, and if all other procedures are carefully followed he can still satisfy himself quite adequately as to the cash on deposit.

If he does not prepare the reconciliation originally, that is if the company has it already completed, he should still follow the same procedure he would have followed in preparing a reconciliation. The returned checks must be compared item by item with the reconciliation for the preceding month and with the record of checks issued for the month just ended to determine the checks which are still outstanding. The deposits shown in the bank statement must be compared with the cash receipts per books at the end of the month to ascertain if any deposits were in transit at the year end. Any receipts recorded as received during the month but not recorded by the bank as a deposit must be considered a deposit in transit. Other reconciling items must be carefully scrutinized and documentary evidence obtained for them. The arithmetical calculations in the reconciliation must then be proved.

To insure that the balance per bank statement has not been tampered with, a bank confirmation should be obtained directly from the bank and compared with the amount shown in the reconciliation.

A bank confirmation has several purposes and should never be omitted. First of all, it gives evidence, includable in the work papers, that the bank balance in the reconciliation is correct. It also provides an opportunity to request, of the bank, information as to the existence of notes or drafts payable, contingent liabilities arising from guarantees or endorsements, and the like. Finally, if the balances of all accounts are requested, it may serve to reveal additional bank accounts not shown in the company's books. Because of these possibilities it is general practice to request a bank confirmation from every bank with which the company did business during the year or other period under examination. The general rules for controlling confirmations of course apply to a bank confirmation as well as to any other type of confirmation.

Many auditing concerns have printed confirmation forms to facilitate the confirmation request. Most banks are extremely cooperative in providing accurately and promptly the information requested. If for any reason a bank confirmation is not returned promptly it is generally desirable to communicate with the bank by telephone or to send another request.

Use of a "Cut-Off" Bank Statement. It should be recognized that a bank reconciliation, whether prepared by the auditor from a bank statement received directly from the bank or prepared after careful review of

the company's reconciliation, is not completely reliable. Three possibilities of error exist. In the first place, the list of outstanding checks depends on the company's record of checks issued, which may or may not be complete and accurate. Second, the amount of the deposits in transit is based on the company's cash receipts book, which again may be in error. Finally, there may have been checks written or deposits made which were never recorded in the books at all. Because a bank reconciliation is subject to such errors, no matter how carefully prepared, a supplementary step is required. This is customarily referred to as obtaining and using a "cut-off" bank statement.

A "cut-off" bank statement is a special bank statement obtained for a period of at least fifteen days immediately following the reconciliation date. The auditor must speak to the company officials, who will then call the bank and arrange that the statement be prepared. It will be held by the bank to be picked up by a company representative or mailed to whatever address the company directs.

The first point about such a statement is that it must be obtained by the auditor directly from the bank. There must be no opportunity for company employees to have access to the statement or the canceled checks which accompany it. If it is not mailed to the auditor's office he should accompany the person who is to call for it at the bank and take possession of it immediately. It is then not released by him until all his work in connection with it has been completed.

Another point of importance is that it must be obtained a sufficient number of days after the reconciliation date to permit checks written before that date to reach their destination, be deposited by the payee, and be returned through regular channels to the bank upon which drawn. Ten to fifteen days is commonly considered adequate for this purpose. In some cases the auditor will be on the job long enough to use the regular bank statement at the end of the following month instead of obtaining a special statement. Where that is possible no cut-off statement need be requested but the regular statement must then be obtained direct and used in the same manner as a cut-off statement.

Once the cut-off statement has been received it is used for four purposes as follows:

1. Outstanding checks at the reconciliation date are proved by examining the checks themselves which should have cleared the bank by the cut-off date.
2. Deposits in transit are proved by tracing them into the cut-off bank statement.

3. All checks returned by the bank with the cut-off statement are scrutinized for:
   (*a*) Checks written before the reconciliation date and not recorded.
   (*b*) Checks which might represent unrecorded transfers of funds or attempts to withdraw from the bank amounts deposited during the preceding months to cover a shortage.
4. Any bank charge for returned items such as N.S.F. checks or for any other special purpose are investigated.

The only sure way to discover any checks written before the reconciliation date and either never recorded on the company's books or recorded later than that date is to compare the checks returned with the cut-off statement with the company's record of checks issued. To do this requires sorting the checks in numerical order, which may become a long and tedious task. It is unlikely that any checks written in the ordinary course of business will be omitted from the records. The kinds of checks which are likely to be omitted are those made payable to "Cash" or to an individual (rather than a business firm) or to some other payee, which makes it possible to obtain the proceeds of the checks. Hence it may not be necessary to compare all checks with the record but to search instead for those checks having unusual payees.

For this reason many auditors confine their scrutiny of checks returned with the cut-off statement to the endorsements on the back of the check. Most companies endorse checks with a rubber stamp. Therefore ordinary rubber stamp endorsements are passed as satisfactory. Handwritten endorsements or checks with no endorsement at all are investigated until it is certain that they represent legitimately authorized transactions and that they were recorded as a cash disbursement when issued.

In using the cut-off bank statement care must be exercised to discover any checks apparently drawn after the balance sheet date which were recorded as deposits in other bank accounts before the balance sheet date. As pointed out earlier, a bank reconciliation is a substitute for a count of the cash in bank. In making cash counts we count all funds simultaneously so that funds borrowed from one fund may not be substituted in another fund to cover a shortage. We have the same type of problem in using bank reconciliations as a proof of the cash on deposit.

Funds may be transferred from one bank to another quite readily by check. Coverage of a shortage in one bank account by means of an unrecorded check drawn on another bank account is known as "kiting" and is a not uncommon method of covering shortages. For this reason

any checks payable to "Cash" or which are made out in such a way that they may be used to transfer funds from one bank account to another require attention. If such checks are returned with a cut-off bank statement they should be carefully traced into the account in which deposited. Unless both the withdrawal and the deposit are recorded as of the same accounting period, the cash balance may not be stated correctly. For example, a transfer of funds from Bank *A* to Bank *B* represented by check number 506 for $5,000 could be included as part of the balance in both accounts if it were recorded as deposited in Bank *B* on December 31 but was not entered as a disbursement from Bank *A* until the following January. Transfers from branches to home offices, from bank to bank in the same city, and advances from one office to another must all be investigated carefully to make sure that no double counting has been effected.

Errors of this kind may be either intentional or unintentional. They are most likely to occur when a company has many branches with many bank accounts and the consequent necessity for frequent transfers of funds.

If a cut-off statement is obtained and used properly, the bank reconciliation may then be relied on because every item in it has been verified by reference to outside, dependable sources. Without the use of a cut-off statement, reliance upon a reconciliation is not warranted.

Some auditors recommend that a complete bank reconciliation be prepared on the cut-off date. If the steps suggested are followed when the cut-off statement is received, very little additional proof, if any, is provided by reconciling the book balance to the bank balance at the cut-off date. For that reason it is generally considered unnecessary. If the internal control were weak or if there was suspicion of fraud, however, it might be worth the additional time and effort.

Agree Cash Balances with General Ledger. Some companies carry a single general ledger Cash account supported by a subsidiary ledger or other record of the individual funds and bank accounts making up the total. Others carry a general ledger account for each fund. No matter what the practice is, the total cash counted or determined by reconciliation must be tied in with the general ledger record of cash and any differences satisfactorily accounted for. The purpose of the verification work is to substantiate the accounting data of which the most significant are in the general ledger. An auditor must never forget that his verification efforts are directed at proving the reliability of the general ledger data and should tie to these data at every opportunity.

Adjusting Journal Entries. If there are included within the balances of the cash accounts any noncash items such as postage stamps, unreimbursed expense vouchers, postdated checks, I.O.U.'s, or cash in closed banks or restricted bank accounts, these should be transferred to more appropriately titled accounts so that when financial statements are prepared they will be given correct treatment. Reliance upon good accounting principles should be required by the auditor in the financial statements which he approves. Adjusting journal entries should be used wherever necessary to bring the existing records into agreement with generally accepted principles and practice.

PROBLEMS—CHAPTER 7

Problem 7–1. Your client, who sells on credit, has several bank accounts. A reconciliation of one of these accounts as of the balance sheet date appears as follows:

Balance per bank, December 31, 1950	$5,000
Add: Deposit in transit	1,000
Total	$6,000
Less: Outstanding checks	50
Balance per books, December 31, 1950	$5,950

The book balance of $5,950 is shown as cash on the balance sheet. As to the $1,000 shown as a deposit in transit, you are to: (*a*) briefly describe the major possibilities of fraud or error; (*b*) list the audit procedure that might be followed in a regular annual audit which would help to verify the deposit in transit. Explain fully how these procedures would help to verify the deposit in transit and detect possible fraud or error. (AIA)

Problem 7–2. At the end of the fiscal year a company's accounts show overdrafts in its two banks. The account with the First National Bank shows an overdraft of $1,000, but there are outstanding checks aggregating $3,000, and the bank certificate shows a balance of $2,000 to the company's credit. The account with the Second National Bank shows an overdraft of $1,200, but checks to the amount of $4,000 are outstanding, and the bank certificate duly shows a credit balance of $2,800. The $4,000 outstanding checks are, for good reasons, held in the treasurer's department. They were produced for the auditor's inspection and soon thereafter mailed to the payees. No discrepancies or irregularities are found after the usual thorough check of the cash transactions. How will you deal with this on the balance sheet and on the books? Give reasons. (AIA)

Problem 7–3. Outline a procedure for use of an independent auditor who is verifying cash on hand in a department store at the close of its fiscal year under the following conditions:

(*a*) Cashier receives all payments by charge customers and records them through a cash register.

(*b*) Cashier has a petty cash fund for sundry operating disbursements.

(*c*) Cashier keeps a record of all change funds. The change funds are fixed amounts and each salesperson has her own fund.

(*d*) Cash sales are recorded by the salespeople through cash register machines.

(*e*) The store's auditor has the keys to the cash registers. At the close of the business day, the auditor pulls the cash register tapes.

(*f*) The auditor, on the next day, prepares a report of cash register readings (indicating the cash sales recorded by each salesperson) and sends the report to the accounting clerk.

(*g*) At the end of each day, the salespeople bring their change bags to the cashier's office. The change bags include the day's cash sales receipts as well as the fund amounts.

(*h*) Before he leaves the office, the cashier prepares the day's receipts for the deposit that is made on the following day.

(*i*) Independent auditor is present on last day of the fiscal year. (AIA)

Problem 7–4. Describe five methods that may be employed in the abstraction of (and failure to account for) cash receipts in a company that makes both cash and charge sales. For each of the above methods, state the internal control procedures you would recommend in order to prevent the fraud and the audit procedures you would employ to discover the fraud. Your internal control recommendations should not be predicated upon the existence of controls other than those which you specifically mention in your answer. (AIA)

Problem 7–5. Describe five methods that may be employed in the making of fraudulent disbursements. For each method, state the internal control procedures you would recommend in order to prevent the fraud and the audit procedures you would employ to discover the fraud. Your internal control recommendations should not be predicated upon the existence of controls other than those which you specifically mention in your answer. (AIA)

Problem 7–6. What purpose is served by obtaining bank statements and paid checks as of a date later than the close of an accounting period? State how such statements and paid checks are utilized by the auditor. (AIA)

Problem 7–7. On the balance sheet date, the company under audit has a large amount of undeposited cash and checks received on the last day of the period. What procedure will you follow in auditing these amounts? (AIA)

Problem 7–8. You are making an examination of the accounts of an importer as of December 31. Draft a form of confirmation letter for submission to the sole bank with which your client does business. (AIA)

Problem 7–9. Why is a second bank reconciliation at a date subsequent to the balance sheet date desirable as part of the verification of cash in bank? What special procedures are of primary importance in connection with the second reconciliation? (AIA)

Problem 7–10. You are engaged in an audit for the year ended December 31, 1954, and propose to count the petty cash fund at the opening of business January 1, 1955. The petty cash is carried in an imprest fund in the amount of $2,000. Set forth detailed instructions with respect to the examination of petty cash and recommendations for related adjustment entries. (AIA)

Problem 7–11. You are assigned to the petty cash count for the Wrakit Company at December 31, 1954. The contents of the fund are as listed below. Prepare work papers to record your count and a list of such adjusting entries as you feel are necessary. The custodian of the fund is S. T. Catchpenny, office manager. From the general ledger account balance you discover that the fund balance is $500; the fund is on an imprest basis.

Contents of Fund

Ten-dollar bills: 5
Five-dollar bills: 7
One-dollar bills: 18
Fifty-cent pieces: 2 rolls of 20 and 7 loose
Twenty-five-cent pieces: 2 rolls of 20 and 14 loose
Dimes: 4 rolls of 50 and 35 loose
Nickels: 5 rolls of 20 and 7 loose
Pennies: 168 loose
Postage stamps of various denominations: $24.17
A receipt for $75 advanced to R. Oakes, a company salesman, dated December 10, 1954
A receipted bill from the *Post-Dispatch* for advertising: $14.75
A receipted bill from Office Supply Company for typewriter and carbon paper: $22.80
A receipted bill from Boyd's Delicatessen for refreshments served at employees' office party, December 24, 1954: $83.80
A receipted bill from Erickson's Super Service Station for gas and oil for company delivery truck: $8.65
An I.O.U. signed by the company treasurer for $50
A check signed by E. Cluff, an employee, dated December 28, 1954: $35
A check signed by S. D. Handy, sales manager, dated January 20, 1955: $150
A notation on a sheet of paper as follows: "Proceeds of vending machines and employees' donations for office party: $111.75"
A check for $18 signed by Royal Oakes, one of the company's salesmen. Attached to the check is a slip of paper with the notation "Return of excess travel advance, December 27, 1954"

Problem 7–12. In connection with an audit you are given the following work sheet:

Bank Reconciliation

DECEMBER 31, 1952

Balance per ledger 12/31/52		$17,174.86
Add:		
Collections received on the last day of December and charged to "cash in bank" on books but not deposited		2,662.25
Debit memo for customer's check returned unpaid (check is on hand but no entry has been made on the books)		200.00
Debit memo for bank service charge for December		5.50
		$20,142.61
Deduct:		
Checks drawn but not paid by bank (see detailed list below)	$2,267.75	
Credit memo for proceeds of a note receivable which had been left at the bank for collection but which has not been recorded as collected	400.00	
Check for an account payable entered on books as $240.90 but drawn and paid by bank as $419.00	178.10	2,945.85
Computed balance		$17,196.76
Unlocated difference		200.00
Balance per bank (checked to confirmation)		$16,996.76

Checks drawn but not paid by bank

No.	Amount
573	$ 67.27
724	9.90
903	456.67
907	305.50
911	482.75
913	550.00
914	366.76
916	10.00
917	218.90
	$2,267.75

Required: (*a*) Prepare a corrected reconciliation. (*b*) Prepare journal entries for items which should be adjusted prior to closing the books. (AIA)

Chapter 8

VERIFICATION OF CASH AND CASH TRANSACTIONS, continued

As pointed out in Chapter 7, procedures with respect to the verification of cash may be directed at discovering if (*a*) all cash is present that is said to be present or (*b*) all cash is present that should be present. Those audit procedures directed primarily at discovering whether the cash as stated is correct are discussed there. In this chapter attention will be given to those procedures that are most useful in discovering whether any cash that should be present has been abstracted.

Detail Work on Cash Account Entries. In connection with proof of the Cash account balance it is generally necessary to (*a*) foot and cross foot the basic cash records, (*b*) trace postings therefrom into the Cash account, and (*c*) foot and prove the balance of the Cash account. The reason for testing footings of books of original entry, for footing and balancing ledger accounts, and for tracing postings from books of original entry into the ledger is discussed in Chapter 3. At no point in the verification work are these steps more important than when applied to cash. Not only is cash the asset most likely to be appropriated by those to whom it does not belong, but also because of the great number of cash transactions the possibilities for hiding or covering thefts are many and continual alertness is required if errors are to be uncovered.

It should be remembered that the intention of these steps is to prove the entries in the Cash account all the way back to the basic source of the cash figures. Proving the footings of the cash receipts and cash disbursements books themselves may not be sufficient. If the entries in those records are summaries of other subsidiary memorandums, remittance slips, cash register tapes, or anything of that nature, the proof of footings must go back to those underlying records.

In tracing postings, the question frequently arises of how much detailed posting to verify from the "miscellaneous" or "general" columns of a columnar book of original entry. The important postings are those concerning the column totals, especially for cash itself, and the individual amounts in a "miscellaneous" column are seldom of vital im-

portance. Hence, it is common practice merely to test the postings of such items with emphasis upon the larger amounts rather than to insist that every individual amount, no matter how small, be traced into the general ledger.

Examination of Documentary Evidence. As evidence of the validity of the entries in the cash books, reference must be made to the documents which give the details of the transactions. For cash disbursements this is a relatively easy matter because paid checks returned by the bank should be available for all major disbursements and petty cash vouchers should be on hand to prove the minor disbursements. It should be noted that, in preparing a bank reconciliation, most of the checks for the month of reconciliation will have been examined. Hence, some of this work has been done and it need be expanded only as necessitated by the degree of internal control in operation.

Most concerns follow a practice of requiring all major disbursements to be made by check with only minor disbursements made from a petty cash fund. Thus verification of disbursements must be directed first at the larger expenditures and then at the petty cash transactions. Whether a petty cash book for recording such disbursements is used or not, reimbursement of the petty cash fund must come from the general cash and should be evidenced by a general cash voucher. In verifying petty cash transactions by examination of vouchers, receipts, and the like, an auditor must make sure that the vouchers submitted to him support the general cash reimbursement voucher. If, for example, it is possible for the petty cash cashier to obtain from the files once-used petty cash vouchers, to alter them in such a way that they can be used again, and to then resubmit them for another reimbursement, an auditor must take real care to see that reimbursement vouchers are properly supported, that is, that each of them has attached to it or that there are available in the file enough valid petty cash vouchers to add up to the total of the reimbursement. Any shortage of supporting petty cash vouchers suggests that some of them have been removed for improper reuse.

Some people have the impression that a petty cash fund is so small that any fraud or defalcation in its use must be so insignificant as to be worthy of little attention. This is untrue for several reasons. First, many petty cash funds are considerable in amount, often running to several thousand dollars. Second, even a small fund of, say, \$100 if reimbursed every two weeks, might have as much as \$2,000 to \$3,000 passing through it in a year. Finally, any fraud or defalcation, no matter

how small, is serious because its successful accomplishment is very likely to encourage the perpetrator to extend his efforts into some other area. Because petty cash transactions do offer a real possibility for errors they must be given serious attention in the verification program.

The examination of documentary evidence of cash receipts is often difficult and sometimes impossible. Some companies include in their internal control procedures the preparation of remittance advices to serve as an accounting department record of each remittance received. Others have the mail clerk prepare a list of all checks received in each day's mail to be forwarded to the accounting department for such use as may be necessary. Such records together with any adding machine tapes do provide a reasonably satisfactory means of verification although it should be noticed that none of these is supplied by independent outside sources. Occasionally customers include a statement of items to be paid with their checks and if these are filed they provide valid evidence. The difficulty, however, is that all customers do not follow this practice, so it is impossible to tell which ones are actually missing.

Other companies make no detailed record of cash receipts. Some even go so far as to forward the checks themselves to the accounts receivable department for posting to the individual accounts receivable. When this occurs it becomes extremely difficult to prove the entries in the cash receipts book. This is not as great a weakness in verification as it appears, however, because to a considerable extent some of the procedures directed at verifying accounts receivable, discussed in Chapter 9, have the effect of proving cash receipts as well.

Miscellaneous cash receipts from such sources as scrap sales, disposal of fixed assets, and collections of accounts written off as uncollectible are always a problem and, of course, become more so if no control procedure requires the preparation of documentary record of the transaction. These are discussed in connection with the other subjects to which they relate throughout the book.

Scan Cash Discounts. The use of cash discounts as a business practice is declining, yet they are still used widely enough to warrant special attention here. The danger of cash discounts, from the audit point of view, is that:

1. Through negligence, discounts may be given to customers after the expiration of the discount period.
2. Discounts may be given to customers in excess of the stated rate or after the discount period has elapsed and the proceeds shared

through collusion between the customer and the employee giving the discount.

3. Discounts may be recorded per books, either at an excessive or at the appropriate rate, when no discount has been taken by the customer, the employee entering the discount then taking that amount of cash for personal use.

The first two of these are unlikely to be of a serious nature. Unless the customer takes the discount, thus remitting less cash than the full amount of the invoice, there is little likelihood that he will be given the discount through negligence. Occasionally, a review of cash discounts granted is in order to watch for this very possibility but in general there is little danger. Collusion between an employee and an outsider is always a possibility but again a very unlikely one. Auditing procedures, if directed at discovering all possible collusion, would be so extensive as to be impracticable, and in this case at least the risk does not justify the added time and expense.

The last one, that of employees' granting excessive or even normal discounts when no discount was taken by the customer in order that they may then extract that amount of cash for personal use is a type of defalcation which has been practiced time and again. It should be apparent that this is not a problem unless the employee has currency available to him. If all receipts are in the form of checks, it is extremely difficult to convert them to personal use although never completely impossible. Assuming that one does have access to some currency receipts as well as to checks, he can enter discounts to cover the currency which he has taken for his own use. If the employee who has the responsibility of granting and entering discounts to customers has no access to currency receipts there is little likelihood of such abstractions; if he does have access, the verification procedures adopted must definitely take the possibility of such transactions into account.

In most cases the rate of cash discounts is uniform so that a careful scanning of the cash receipts book will indicate whether discounts excessive in amount have been entered. If any have been, it is essential that a satisfactory explanation, preferably from someone other than the person who granted the discount, be obtained. Scanning will not locate improper discounts recorded at the customary rate. Thus, if this seems a real possibility it may be worth while to trace all discounts granted for a given period, generally no more than a month, back to the date the cash was received and to the sales transaction itself. This will show whether a discount was actually offered and at what rate, and will also show whether the invoice was paid within the discount period.

It is generally desirable to compute the rate which discounts granted bear to total sales or to sales on account for the period under examination. Any tendency for this rate to grow should be inquired into and unless satisfactory explanation is given, further expansion of the tests suggested in the preceding paragraph is in order.

Review Bank Reconciliations. Some attention should be given to bank reconciliations made by the company during the year because of the opportunity they give to cover, temporarily at least, any difference between cash in the bank and cash per books. It is generally unnecessary to review more than a portion of the reconciliations for the entire year unless the internal control procedures appear weak. In requesting the company employees to make them available, however, all reconciliations for the year should be requested so that the extent of the testing is not made obvious.

In reviewing bank reconciliations, an auditor should have in mind the type of coverage which reconciliations afford. He should prove the arithmetic, watch for the recurrence of similar amounts in the list of outstanding checks or deposits in transit, especially large or round amounts, make sure that the balances shown as per books and per bank actually tie in with those records, and investigate thoroughly any unusual or unexplained reconciling items. It should be fully understood that a shortage could be concealed for several months by careful coverage within the bank reconciliations, and, if the funds were returned to the bank before the end of the year, might come to light in no other way than through the careful review of the bank reconciliations concerned.

Reconcile Transactions per Bank and per Books. The requirement that all cash received each day be deposited in the bank intact and that all cash disbursed, except for minor amounts, must be disbursed by check are two of the fundamental rules of internal control over cash and have been widely adopted. This is of considerable advantage to an auditor and gives him the basis for an extremely valuable test.

If all cash received is to be deposited immediately, any failure of bank deposits to agree with cash receipts indicates either that some cash receipts have been held out and not deposited or that for some reason more cash was deposited than was received, possibly to cover a previous shortage. In either case, a satisfactory explanation must be obtained or the conclusion that something is amiss follows. The same is true of cash disbursements. If checks written per books are greater or less than checks paid by the bank, again it appears that something is amiss and further investigation is required.

In attempting to reconcile transactions per books with the transactions per bank, such items as deposits in transit and outstanding checks must be taken into consideration. As indicated by a bank reconciliation, there is always something of a lag between the book and bank transactions. This must be taken into account in reconciling transactions as well as balances.

For example, deposits per bank of $5,650 might be reconcilable to cash receipts per books of $5,800 because of a deposit in transit at the beginning of the month of $250 and a deposit in transit at the end of the month of $400. If we are attempting to work from the deposits per bank to the receipts per books the reasoning would be as follows:

Deposits for the month per bank statement	$5,650
Deduct deposit in transit beginning of month which was recorded as a deposit during the current month by the bank but not in the books	250
	$5,400
Add deposit in transit at the end of the month which was recorded as a receipt per books but not as a deposit per bank	400
Receipts for the month per books	$5,800

The reconciliation of disbursements and checks paid by the bank can be illustrated in the same fashion.

Disbursements for the month per bank		$6,225
Less:		
Outstanding checks at the beginning of the month considered as disbursements during the current month by the bank but not in the books	$925	
N.S.F. check received from a customer returned by the bank and considered by the bank as a disbursement during the current month but not yet recorded per books	150	1,075
		$5,150
Add:		
Outstanding checks at the end of the month considered as disbursements during the current month in the books but not by the bank	$800	
Bank charges for the preceding month entered in the books during the current month	10	810
Disbursements for the month per books		$5,960

Any failure of the book receipts and disbursements to reconcile with those shown in the bank statement indicate either omitted or improperly included transactions to be investigated further. The problem of how to evaluate the information disclosed by thus reconciling book and bank transactions is discussed later in this chapter.

So-Called "Proof of Cash." Some auditors combine the reconciliation of bank and book transactions with the beginning and ending cash balances per books and per bank in the following work sheet form, giving to it the title "Proof of Cash." This is an extremely useful work sheet and one with which every auditor should be familiar. It does not, however, "prove" cash and unless supported by other tests and verification procedures may lead to erroneous conclusions. As with any other auditing device, attention must be given to its weaknesses as well as its usefulness.

If the data in the preceding reconciliations of receipts and disbursements are used together with such other data as are required, a proof of cash might appear as follows:

THE SIMPLE COMPANY

PROOF OF CASH FOR DECEMBER 1955

	Balance 11/30/55	December Receipts	December Disbursements	Balance 12/31/55
Per bank statement	$3,425	$5,650	$6,225	$2,850
Deposits in transit				
At Nov. 30	250	(250)		
At Dec. 31		400		400
Outstanding checks				
At Nov. 30	(925)		(925)	
At Dec. 31			800	(800)
Other reconciling items				
November bank charge	10		10	
December N.S.F. check			(150)	150
As per books	$2,760	$5,800	$5,960	$2,600

In studying a work sheet of this type, consideration must be given to the following matters:

1. Source of data for the work sheet.
2. Procedure to be followed in completing the work sheet.
3. Reading the work sheet after it is completed.

4. Supplementary work required before work sheet can be relied on.
5. Method of treating any errors found.

A study of the proof of cash will show that the top line across the sheet is a summary of the transactions for a month as shown in the bank statement. Beginning and ending balances are always shown on the statement and can be copied directly into the work sheet. Total receipts can be obtained by adding the deposits column on the bank statement, and disbursements can be obtained by adding the amounts for checks paid. Because the check amounts are not recorded in single column fashion and because there may be so many of them, it is standard practice to obtain the total checks per bank statement by subtraction: beginning balance plus receipts less ending balance equals disbursements. Thus all items in the first line are taken from the bank statement and should be so indicated by tick mark and explanatory comment or otherwise.

The bottom line is a summary of the cash transactions as recorded in the books. This should be taken directly from the books, preferably from the Cash account itself, which should, of course, show receipts and disbursements as debit and credit entries and the balance in the information column.

Further study will show that the left-hand column is a bank reconciliation at November 30 and the right-hand column a bank reconciliation at December 31. This may not be the bank reconciliation form to which one has become accustomed, but it does reconcile the bank and book balance on that date and therefore does constitute a reconciliation. It is also an entirely satisfactory form once one becomes accustomed to working with it. The information in these two columns may be taken from bank reconciliations previously prepared or may be entered on the work sheet as the reconciliation steps are performed. If used as a bank reconciliation it must be supported by a list of outstanding checks and other explanatory information.

The two center columns, receipts and disbursements, are the important columns of the work sheet and are the reason why the other data are brought together. Everything needed to complete these center columns may be found in the figures included in either the top or bottom lines or in the left- and right-hand columns; no new data need be added.

The procedure in preparing the work sheet should be that followed in describing the source of the data used. First, the top and bottom lines and then the two outside columns should be filled in. Not until they

have been completed should the more difficult receipts and disbursements columns be attempted.

In reading the work sheet illustrated it is apparent that all is in order. The bank reconciliations of the beginning and ending balances work out satisfactorily, and the receipts and disbursements as stated in the books reconcile to those shown in the bank statement. If, however, any column in the work sheet did not foot to the respective book figure, a discrepancy would be indicated which would require investigation. If, for example, the cash receipts column actually added to a figure of $23,000, whereas the cash receipts book for the month gave a total of $25,000, it would appear that $2,000 of cash receipts was never deposited. If at the same time the cash disbursements book showed a total of $28,000 whereas the column total for disbursements in the work sheet was only $26,000, it would appear that the disbursements per books were overstated for some reason. If we put the two errors together it appears that someone may have abstracted $2,000 from cash receipts and attempted to cover his theft by overstating disbursements by the same amount. The overstated disbursements would reduce the cash balance in the books to agree with the bank account balance, and the error might have been given permanent coverage.

Other problems of reading this type of work sheet are discussed in connection with further illustrations.

In preparing the work sheet, the actual book figures for balances, receipts, and disbursements are used. Of course, these may be in error and if so cannot be relied on. Thus, as supplementary verification, the cash figures taken from the books must be proved. If, for example, balances, receipts, and disbursements are taken from the general ledger account for cash, that account must be footed and balanced for each of the dates concerned, the entries must be traced back to the cash books, and those records must be footed. Only if this is done are the conclusions drawn from reading the work sheet dependable.

Likewise the reconciling items in the two bank reconciliations included within the work sheet must be worked out as carefully as if the auditor were preparing the reconciliations. No amounts in the work sheet can be taken for granted; all must be proved by one of the basic verification techniques.

The following illustration indicates how any errors found in an actual case might be shown in the work sheet. It does not include all possible errors, of course, but does include sufficient that one can understand the basic methods of showing them, once discovered.

THE ERROR COMPANY

PROOF OF CASH FOR JUNE 1955

	Balance 5/31/55	June Receipts	June Disbursements	Balance 6/30/55
Per bank statement	$17,970	$50,200	$42,890	$25,280
Deposits in transit				
At May 31	1,500	(1,500)		
At June 30		900		900
Outstanding checks				
At May 31	(4,500)		(4,500)	
At June 30			4,000	(4,000)
Other items				
May bank charge	30		30	
June bank charge			(20)	20
June N.S.F. check			(300)	300
Total	$15,000	$49,600	($42,100)	$22,500
Excess of books over bank	1,000			
Excess of bank receipts over book		(1,000)		
As per books	$16,000	$48,600	$42,100	$22,500

This work sheet indicates that, at the end of May, the book balance exceeded the bank balance by $1,000. That is, $1,000 of company funds which, according to the book record, should have been in the bank was not there. During the month of June there was deposited in the bank a total of $1,000 more than should have been deposited as shown by the cash receipts per books. If we put these two together it appears that someone "borrowed" $1,000 sometime previous to May 31 and returned the amount sometime during the month of June. Thus at the end of June the balance per bank and per books reconciles with no difficulty.

The method of showing discrepancies in this work sheet is quite satisfactory for almost any kind of difference that might occur. A different sort of question occurs when an error is discovered in one of the book figures. For example, let us assume that in footing the cash disbursements book for June it is discovered that the actual cash disbursements per books should have been $49,600 rather than the $48,600 shown as the total of the cash column and posted to the general ledger. Which amount should then be shown in the work sheet? The bottom line of the work sheet should show the book amounts as they appear in the books, not as they should appear if corrected. Then, if there is an

Clement Company
Proof of Cash Transactions
December 31, 1954

RHM
2-7-55

	Balance 11/30/54	Receipts	Disbursements	Balance 12/31/54
Per bank statement	32424 21	115829 71	120359 61	27894 31
Outstanding checks				
November 30	8715 62		8715 62	
December 31			3295 60	3295 60
Deposits in transit				
November 30	2754 18	2754 18		
December 31		1778 56		1778 56
Bank charges				
November	16 00		16 00	
December			318 50	318 50
Check charged by bank in error in November, corrected in December	185 42	185 42		
	26664 19			26695 77
Per books	26664 19	114668 67	114637 09	26695 77
Deduct December service charge and int. on note - A.J.E. #3				318 50
Balance per audit 12/31/54				26377 27

n Per 12/31/54 bank statement
✓ Per general ledger; account footed and balance proved.
c Per confirmation attached.
F Cash receipts and cash disbursements books for December footed.
✗ Per company's 11/30/54 reconciliation.
✓ See our 12/31/54 reconciliation.
r Copy of letter to bank and 11/30/54 bank statement examined, appear in order.

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Illustration 11. Work sheet for proof of cash transactions.

error discovered in performing some of the supplementary verification, that figure should be noted in some way and a description of the error written on the work sheet. This error must then be given consideration in interpreting the work sheet along with any other errors discovered.

The proof of cash is prepared for a period of one month, as that is the term to which a bank statement applies. It will not, therefore, reveal

any borrowing that takes place within a month that is repaid by the end of the month. Thus a person could borrow from company receipts on June 2 and repay the money by depositing it on June 29 and the temporary shortage would never be discovered through preparation of a proof of cash. Another very simple work sheet is sometimes prepared to locate any "borrowing" of this type. It consists of three columns, one for the date of each working day within the month, one for the cash receipts of each day, and the third for the bank deposits each day, as follows:

Date	Cash Receipts	Bank Deposits
June 1	$500	$530
2	450	500
4	620	450
5	550	620
6	480	400
7	630	480

Such a work sheet should be prepared for an entire month, but the partial application above will suffice for illustrative purposes. In this case it is seen that the receipts for June 1 were deposited June 2, an entirely normal procedure as a day's lag is generally required to get funds deposited. The bank deposit on June 1 would therefore represent the receipts from the day before. The receipts for the days on through June 4 are deposited the following day in every case but the receipts of June 5 were not deposited intact on June 6. For some reason only $400 of the total of $550 was deposited. This requires further questioning and explanation. It may be that the difference of $150 will be deposited later in the month or it may be that some logical explanation is possible. In any case the failure to deposit the full amount of the receipts for the day is brought to light for investigation.

This very simple test should always be applied for at least one month to see what the company practice of making deposits is, and to determine whether it is in line with the established policy.

Compare Detail of Deposit Tickets with Cash Receipts Record. A type of fraud occasionally practiced is that of abstracting receipts from certain customers and covering the shortage with receipts from another customer, which in turn are covered with receipts from other customers received a day or so later. This procedure is known as "lapping." Lapping can be worked out most easily when currency and check receipts are intermingled, but if the person perpetrating the defalcation is willing to forge signatures to checks it can also be worked out with checks alone.

The following simple schedule illustrates how the shortage of cash any one day is covered until the following day.

Date	Actual Cash Receipts		Cash Abstracted		Cash Receipts per Books		Cash Deposited	
May 1	Black	$ 300	Black	$300				
	White	250			White	$ 250	White	$ 250
	Gray	600			Gray	600	Gray	600
		$1,150		$300		$ 850		$ 850
May 2	Brown	$ 680			Brown	$ 480	Brown	$ 680
	Blue	340			Blue	240	Blue	340
	Green	300			Green	300	Green	300
					Black	300		
		$1,320				$1,320		$1,320
May 3	Smith	$ 470			Smith	$ 470	Smith	$ 470
	Jones	560			Jones	260	Jones	560
	Johnson	425			Johnson	425	Johnson	425
					Brown	200		
					Blue	100		
		$1,455				$1,455		$1,455
May 4	Taylor	$ 320			Taylor	$ 320	Taylor	$ 320
	Thomas	550			Thomas	250	Thomas	550
	Larkin	220	Larkin	$220				
	Townsend	460			Townsend	460	Townsend	460
					Jones	300		
		$1,550		$220		$1,330		$1,330

From this tabulation it can be seen that on the first day an amount of $300 received from customer Black was withheld by the cashier and not deposited. This shortage was covered the following day by giving Black credit for amounts paid by Brown and Blue. This meant that those two customers did not receive full credit, so on the following day they were given enough credit to correct the balances of their accounts, and customer Jones was credited with less than the amount he had paid. This in turn was covered the following day by remittances received from Thomas. An additional amount received from Larkin was withheld.

A shortage of this kind may be covered indefinitely by appropriate manipulation of the records. It should be recognized that a clever embezzler will take care to cover shortages within a day or so, so that monthly statements to customers will be in line with what the customer thinks the balance of his account should be. If he also restricts his manipulation to a few accounts and if careful "private" records are kept,

there is little danger of the shortage being uncovered by anyone except a careful auditor.

Reference to the tabulation illustrating this kind of shortage indicates the weak point. The details of the deposit tickets do not agree with the details of the cash receipts book. The actual checks received must be deposited, and, as these do not agree with the amounts of credit to be given to the individual customers, there is a discrepancy in the details of the two records. Note that the totals of the cash receipts book and the total of the deposit ticket are the same for every day except those on which additional amounts were abstracted. Hence, unless the shortage were being increased, the only sure way of uncovering it is a comparison of the details, not the totals, of the two records.

It is seldom necessary to apply this test to a very long period. Most auditors compare the details of the duplicate deposit tickets with the details of the cash receipts book for about five days on each side of the ending date of the period under examination. If there is any shortage it will have to be covered within that many days and especially at a month end when customers receive their monthly statements and are likely to complain unless the balance shown as due is correct.

A further word of caution is necessary. If this test is based on duplicate deposit tickets, there is always a chance that the employee guilty of a defalcation of this kind will cover his tracks by destroying the real duplicate deposit tickets and then preparing false ones which do agree with the details of the cash receipts book. To counter such an effort, it is common practice to send copies of the deposit tickets to be used in the test to the bank with a request that the bank compare them in detail with the original deposit tickets which it has on file. If the authenticated slips are then returned directly to the auditor, he can assume that they are correct and therefore constitute a valid basis for completing the test.

Even if this is done, however, an auditor cannot be completely sure of the detail on the authenticated duplicate deposit tickets. Bank officials have stated that in many cases in which they have been asked to authenticate duplicate deposit tickets they have compared only the total with the original deposit ticket and no more. This means that an auditor must be careful to request specifically that the details be checked, and if there is any doubt as to whether the bank actually compared details he should get in touch with the bank by telephone or otherwise to assure himself as to whether the information on the deposit tickets is reliable.

Account for All Check Numbers. A missing check can mean a transaction either unrecorded, unauthorized, or both. Hence, it is common

practice for an auditor to account for all check numbers as a precaution against any checks being hidden or written and not recorded. Indeed, the numerical integrity of any series of documents should always be proved if that is at all practicable. Although the possibility of fraud or defalcation may be remote, yet it is a real service to the company under examination to prove that all documents have been accounted for and that no transactions are unrecorded.

Examine Checks Outstanding at Previous Audit Date. The use of a cut-off bank statement to give an auditor a chance to satisfy himself as to the legitimacy of the outstanding checks has already been described. In some cases all outstanding checks are not returned with the cut-off statement for one reason or another and the auditor cannot examine them. Unless he has some reason to question the validity of the transaction, which he can usually prove by some other means, he must pass those checks as valid without ever actually examining them. If he then comes back on a repeat engagement at a later date it is only common prudence to call for those checks so that he can examine them for any irregularity.

PAYROLL BANK ACCOUNTS AND PAYROLL TRANSACTIONS

A special class of cash transactions consists of payroll payments to employees. These are different from other cash disbursements in that they are not based on an invoice or similar document and are issued in considerable numbers at stated intervals. With the use of checks rather than pay envelopes containing cash and with the requirement of social security tax reports of various kinds, payroll frauds have been reduced considerably. Yet the possibility of intentional as well as unintentional error is always present, and careful verification must be applied to this type of cash disbursement as well as to all others.

Types of Payroll Error. In the preparation of payrolls, a considerable variety of possibilities present themselves. Some of these are unintentional errors, but most payroll procedures are set up in such a way that unintentional errors are likely to be revealed by the workings of the system. Intentional errors are more likely to be difficult of discovery because of the possibilities for concealment. Discovery of the following possibilities must be provided for in establishing a satisfactory

audit program unless the internal control in effect makes them absolutely impossible.

1. *Inclusion of fictitious employees on the payroll.* This results in the preparation of checks or pay envelopes for people not actually working. The person responsible for this type of error must then obtain the checks or pay envelopes and convert them to his own use.

2. *Continuance of separated employees.* When an employee leaves his job permanently it is sometimes possible to continue his name in the payroll listing so that a check is prepared for him. As with the inclusion of fictitious employees, to benefit from this type of error the perpetrator must obtain the payroll check and convert it to his own use.

3. *Conversion of unclaimed wages.* When employees sever their employment during a pay period they sometimes neglect to return on the following pay day to obtain their checks or to make other arrangements to obtain their final pay. This makes it possible for someone to obtain those checks and convert them to his own use.

4. *Overfooting of payroll sheets.* Under most payroll systems, a separate bank account is used to disburse payroll checks. This is desirable in order that special provisions for check signing, less strict than for general cash checks, can be established. The amount to be deposited in the payroll bank account is generally the net pay, i.e., gross pay less deductions for income and social security taxes, any hospitalization or insurance costs, and the like. If the payroll can be overfooted so that the total net pay appears larger than it really is, an amount in excess of the individual checks will be deposited. This can then be withdrawn with little difficulty by use of a forged payroll check because of the less stringent requirements for signing and approving payroll checks.

5. *Overstated rates.* Gross pay is the result of multiplying the hours worked by the rate of pay. An error in the rate of pay will result in giving the employee either more or less pay depending on the nature of the error. In most cases he will complain if the rate is too low and may do so if the rate is too large. As a practical matter, either type of error is bad but the more likely one is an overstated rate.

6. *Overstated hours.* The same results may be obtained by entering on the payroll summary an incorrect number of hours.

7. *Erroneous extension.* In multiplying the rate times the hours there is of course an opportunity for an incorrect result with incorrect pay following.

8. *Understatement of deductions.* If the various amounts to be deducted from gross pay are understated in total, probably as a result of underfooting, then the same result is obtained as if the net pay column

were overfooted. The total net pay will be stated larger than actual and funds will be made available to the person in charge of preparing or signing payroll checks.

As might be expected, a series of audit procedures has been developed to uncover any such errors as the above. These procedures are all variations of the basic verification techniques discussed previously adapted to the needs of payroll verification. It goes without saying that in any given payroll situation further modifications might well be in order.

Program for Payroll Verification. Most of the steps in the verification of payrolls are simple ones and relate directly to the errors described in the preceding section. Likewise, all would be applied on a test basis, the amount of the sample varying with the extent and efficiency of the internal control.

The following steps should be included:

1. Foot payroll sheets and tie net payroll in to disbursement record.
2. Trace names on payroll sheets to personnel files for authenticity.
3. Trace names on payroll sheets to social security reports.
4. Compare returned checks with payroll, examining amounts, payees' signatures, and endorsements.
5. Trace rates on payroll sheets to wage rate authorizations in personnel file, to union contracts, or to some other reliable source.
6. Trace hours shown on payroll sheets back to time clock cards, to paymaster's reports, or to some other reliable source.
7. Verify extensions by recomputation.
8. Trace all payroll amounts, gross pay, net pay, and deductions, into the books of original entry and the general ledger, scrutinizing entries for propriety.
9. Reconcile payroll bank account.
10. Supervise distribution of payroll checks to employees and follow up any unclaimed checks.

Most of these procedures are self-explanatory, and their intent is not difficult to determine. A few words on some of them may not be out of order, however. The use of social security tax reports in the verification of payroll transactions has a twofold purpose. It is some evidence that the transactions are valid, and it provides an opportunity to ascertain whether the company is fulfilling some of the reporting and record-keeping requirements of the law. Tracing names to the social security tax form is not complete evidence that the employee is a real person actively engaged in working for the company because a deter-

mined person could easily obtain more than one social security card under a variety of names. Likewise, friends or relatives could be included on a payroll who were real people with account numbers and cards but who did no work for the company. Thus, although this test is useful, it should never be regarded as conclusive in itself.

The supervision of the distribution of payroll checks to employees is not a common verification procedure, chiefly because good internal control makes it unnecessary. However, where there is some danger of padded payrolls or of unclaimed wages getting into the wrong hands it is an extremely valuable device. It should, of course, always be a surprise to the individual responsible for distributing the checks as any advance warning to him gives him an opportunity to conceal his activities by some other means.

MISCELLANEOUS CONSIDERATIONS IN CASH EXAMINATIONS

Timing of Cash Counts. Any advance notice to a custodian that his fund is to be counted on a certain day gives him adequate warning to set things right by that time. Thus, if cash is always counted on the last day of the fiscal year, it is almost certain that all funds will be found as they should be. It may be necessary for a custodian to borrow funds to replace those he has misappropriated, but if he is given sufficient notice he can generally accomplish the necessary coverage. Hence, the element of surprise in cash counts is always desirable. Almost any date other than the last date of the fiscal year has some of the advantages of a surprise count.

It should be understood that the amount of cash in a fixed fund can be verified at dates other than the audit date. If the fund is intact at the time of a surprise count on some interim date reasonably close to the year end, there is reason to believe that it was or will be intact at the year end. Should there be any reason for doubting this, some attention can be given to proving the transactions between the date of count and the year end date.

Months to Be Selected for Detail Work. In choosing from among the months within the period to be examined those which are to be given detailed attention, that is, in footing books of original entry, tracing postings, and examining underlying documents, it is common practice to select those which include the largest number of transactions or those of largest amounts. This is not always desirable because intentional

errors can be made at any time, and people with a tendency toward deception might discover that the auditor always selects the most active months and will then plan their own activities accordingly. Therefore it is generally wise to follow no set pattern of selecting the busiest month but rather to vary by occasionally selecting months in which relatively little business was done.

Considerable attention is of necessity given to the cash transactions for the last month of the year because of the preparation of bank reconciliations at the year-end date. This means that the last month of the year is generally one of those selected as one of the months to be included. This is reasonable from the point of view of proving cash balances but may not be so useful in verifying cash transactions, especially if the auditor's concentration on that month is well known.

Some auditors have the feeling that a person making personal use of company funds will very likely try to cover his shortage during the last month of the year and then withdraw the funds again the first month of the following year. Therefore they give special attention to cash receipts and bank deposits for the last month of the year under examination and to cash disbursements and checks paid by the bank the following month or at least during the cut-off period.

Another possibility is to so vary the tests that over a period of four or five years the transactions of all months are given some attention. It is generally unwise to scatter the tests in any one year so that a little is done in each month, unless an extremely large amount of testing is to be done. Most auditors feel that it is more desirable to concentrate the tests on a very few months and to examine these exhaustively than to spread thinly over a longer period of time.

Extent of Work to Be Done. Because of variations in the accounting situations in existence, in the extent and efficiency of internal control systems, and in the types of business operations, it is almost impossible to establish any standards for the amount of audit work to be included. It should be remembered that for a test to be of any real validity it must cover a bookkeeping cycle. Thus for footings, postings, and the examination of underlying documents, a month is the minimum period. For payroll transactions a pay period would be the minimum. This ties in with the theory that, no matter how effective the system of internal control appears, some detail verification is essential to determine whether or not the system as established is actually functioning effectively. Hence, one month is about the minimum to which the detailed verification work can be limited.

Very seldom is it necessary to extend the detailed verification work to every month in the period under examination. Generalizations are seldom safe, but they may be helpful as a rough measure of the extent of verification commonly thought necessary. Keeping in mind that internal control is always the deciding factor and that internal control may be quite satisfactory in some respects but completely lacking in others so that one phase of the verification program might be extended while another is reduced, the following may be suggested as a very rough indication of the amount of detail work required:

Minimum (good internal control)	1 month
Intermediate (fair internal control)	2 or 3 months
Maximum (weak or poor internal control)	6 to 9 months

If internal control is completely missing, then nothing short of a detailed examination of every transaction is adequate to insure that data produced by the system are reliable.

Basic Verification Techniques Used in the Examination of Cash. As cash and cash transactions constitute the first area for which a detailed audit program has been presented, it may be helpful to point out that all the detailed procedures applied rest on the basic audit techniques discussed in previous chapters as methods of obtaining valid audit evidence.

Because cash is an asset that can be seen and handled physically, one would expect that physical examination and count should play an important part in its examination. As discussed in Chapter 7, this is true for cash on hand. However, a considerable portion of a company's available cash will not be present in its own offices to be examined and counted; for internal control purposes it will be kept on deposit in a bank or trust company possessing more adequate facilities for its protection. Verification of cash on deposit calls for employment of additional basic techniques. Confirmation becomes necessary to determine the amount of cash held by each banking institution with which the company has an account. Because the bank supplies a record of all transactions between the company and itself during each month, the bank statement, an opportunity is presented for correlating the record of cash balances and transactions as shown by the company's books with the related bank record, thus adding credibility to the company's record or not as the case may be. Reconciliation of bank balances and transactions with book amounts involves the examination of original documents, recomputation, and correlation with related information.

The audit of cash transactions during a period requires the examination of the original documents representing the transaction, such as paid checks and such evidence of cash receipts as may be available. Recomputation of column totals in books of original entry and in ledger accounts and the retracing of such bookkeeping procedures as posting from the cash journals to the ledger are, of course, required to discover whether the amount shown as the balance of the Cash account is correct. The scanning of the Cash account is called for, and the further scanning of bank reconciliations and recorded transactions may be helpful in permitting more extensive examination than would be possible if only relatively more time-consuming tests were applied. Inquiry is required in one form or another in almost every area of audit work, and such subsidiary records as cash register tapes and duplicate copies of bank deposit slips will be examined for possible inconsistencies or differences with the primary records.

Thus the nature of the audit problem for cash and cash transactions is such that all the basic verification techniques are found useful and even essential. It is not enough, however, to see their general usefulness; an auditor must be familiar with their specific applicability. He must understand the method of application and the purpose to be achieved thereby. This calls for a study of the detailed steps generally followed in the examination of cash and cash transactions. One should never lose sight of the fact, even while studying detailed procedures, that each specific step in the examination program falls back on one or more of the basic techniques previously discussed.

As each additional area of audit work is studied it is well to relate the specific audit procedures described to the basic verification techniques. This is helpful in obtaining a better understanding of the tests applied and also in giving an appreciation of the flexibility and usefulness of the basic techniques.

PROBLEMS—CHAPTER 8

Problem 8–1. On the books of a company is an account called "Exchange Check account," which has many debits and credits but no balance at the end of any month. The controller explains that it represents accommodation purchases for company employees and others. Company checks are charged to the account, checks received from employees and others are credited. Should further investigation be made? Give reasons and discuss. (AIA)

Problem 8–2. In connection with the verification of cash in bank, outline a test audit procedure of cash records to reveal the following irregularities: (*a*) improper borrowings or temporary misappropriations during the period under review which have been restored before the close of the period; and (*b*) misappropriation of accounts receivable collections in process at the close of the period by "kiting" or "overlapping" receipts. (AIA)

Problem 8–3. In tracing checks to the cash disbursements book you find unentered in the last month of the year under review a series of ten checks none of which has been returned by the bank. Inquiry reveals that the checks in question were signed in blank by the treasurer and given to the vice president in charge of sales, who was making an extended business trip which ended two weeks after the close of the fiscal year. He had requested the signed checks, which would then only require his countersignature, to avoid carrying a large amount of cash customarily expended on such trips for the usual traveling expenses, and for entertaining customers and prospects. Outline or briefly explain the following: (*a*) additional auditing procedures you would follow in view of this practice; and (*b*) recommendations you would make to your client to accommodate the vice president's desires in an acceptable accounting manner. (AIA)

Problem 8–4. You are assigning an assistant to examine canceled checks relative to a client's bank account. There are certain types of checks with respect to which you urge him to be particularly alert and inquisitive. Indicate some of these types. (AIA)

Problem 8–5. All employees of a company are paid in cash once a week. The company has 200 employees all of whom work at one plant; 50 of these employees are on a night shift. All employees are paid on Friday (or Saturday morning with respect to the night crew) for the week ended on the preceding Tuesday. One employee, the payroll clerk, prepares the payroll from time sheets signed by the respective foremen. He also checks time cards against these payroll sheets, and hands out the pay envelopes. Pre-

pare a program of audit of payroll in connection with the regular annual examination of financial statements. (AIA)

Problem 8–6. Lapping has been described as a practice in which the improper abstraction of cash out of current receipts is covered by the omission of an entry or entries for receipts represented by checks. These checks are then deposited in lieu of cash abstracted. Later entries are made for the items previously omitted and the shortage is either made up by the return of the cash abstracted or continued by the failure to enter other receipt items. Outline and discuss briefly an audit procedure which would disclose the existence of the practice above described. (AIA)

Problem 8–7. Mention five different methods to which dishonest employees may resort in manipulating payrolls. (Do not give variations of the same method.) (AIA)

Problem 8–8. Information obtained in the audit of the L. A. Schmoo Company is presented below:

1. The balance per the cash account, 12/31/55 amounts to $41,830.
2. The balance in the Crab Orchard National Bank per their confirmation is $39,300 at the close of business 12/31/55.
3. Outstanding checks at 12/31/55 amount to $4,300.
4. An N.S.F. check for $300 has been charged to the account. This check was obtained from a customer on account.
5. Deposit in transit, $6,500.
6. Exchange and collections charges deducted by the bank, to the extent of $30, have not been recorded by the Schmoo Company.
7. The reconciliation data as of 11/30/55 are as follows:

Balance per bank statement, 11/30/55	$39,600
Balance per books, 11/30/55	33,300
Difference (outstanding checks at 11/30/55)	$ 6,300

8. The following is a summary of cash receipts and disbursements according to the books for December 1955:

Receipts (all deposited)	$250,000
Disbursements	241,470

9. Total deposits shown by the bank statement for December 1955 amounted to $242,500.

Requirements: (*a*) Prepare in good columnar form a "proof of cash" reconciling December receipts, disbursements, and beginning and ending balances per bank statement with the book figures. (*b*) Prepare all neces-

sary adjusting entries to correct the cash account. (*c*) State the amount of cash you would show in a balance sheet prepared at 12/31/55.

Problem 8–9. The cash book of the *H-J* Company for June 1955 follows.

Receipts			Disbursements		
June 1	Balance	$ 840	June 2		$ 974
4		1,212	5		813
7		1,870	7		679
8		912	12		1,248
12		1,048	22		1,612
20		1,531	24		1,051
27		1,254	30	Balance	1,990
		$8,367			$8,367

The June 30 bank statement showed a balance at June 30 of $1,965; June deposits of $7,212, and checks paid of $6,597. Cash on hand June 30 amounted to $315, and outstanding checks at June 30 (all issued in June) were $290. According to the bookkeeper for the *H-J* Company, outstanding checks at May 31 amounted to $470.

You are asked to examine the accounts for irregularities and to present a brief report of your findings. Be as specific in your report as possible and submit work papers in support of your report.

Problem 8–10. You are making an audit of a client where the records have been found to be inaccurate and where no satisfactory internal control exists. In connection with the audit you are reconciling the cash transactions for the month of December 1955 in addition to the cash and bank balances as of December 31, 1955. You have determined that the client's reconciliation as of November 30, 1955, is correct. The following information is available to you:

CLIENT'S RECONCILIATION NOVEMBER 30, 1955

Cash per general ledger	$2,631.74
Less: cash on hand	210.89
	$2,420.85
Less: bank service charge for November	9.00
	$2,411.85
Add: outstanding checks	991.00
Balance per bank	$3,402.85

Cash Receipts Book for December

Dec.	1	Balance from 11/30	$ 2,631.74
	1	Received on accounts	403.25
	2	Received on accounts	1,366.40
	3	Received on accounts	974.86
	4	Received on accounts	4,322.47
	5	Received on accounts	5,201.89
	7	Received on accounts	7,310.75
	8	Received on accounts	6,195.18
	9	Received on accounts	8,884.46
	10	Received on accounts	10,227.55
	11	Received on accounts	6,698.89
	12	Received on accounts	210.20
	14	Received on accounts	1,426.46
	16	Received on accounts	400.00
	17	Received on accounts	700.00
	18	Received on accounts	2,709.82
	21	Received on accounts	850.00
	23	Received on accounts	1,100.00
	27	Received on accounts	911.35
	29	Received on accounts	3,875.50
			$65,300.77

Cash Payment Record for December

Dec.	1	November service charge	$ 9.00
	3	Checks	5,236.50
	5	Checks	3,645.21
	8	Checks	16,394.89
	10	Checks	15,873.42
	12	Checks	3,123.47
	14	Checks	475.42
	17	Checks	1,250.00
	19	Checks	3,622.83
	22	Checks	3,692.09
	26	Checks	3,456.45
	31	Checks	4,201.25
		Balance, December 31	4,311.24
			$65,300.77

Cash on hand December 31 amounted to $100. The transactions per the December bank statement, which are correctly recorded by the bank, show that deposits amounted to $62,870.92; checks paid amounted to $57,952.03; service charges for the month were $10; and a charge of $100 was made

against the account because of the return unpaid of a customer's check. Neither the service charges nor the returned check were recorded on the client's books. The total of outstanding checks as of December 31 was found to amount to $4,110.50.

Prepare appropriate working papers together with any explanations you consider necessary, based on the data given herein. (AIA)

Problem 8–11. A company, whose general office is in New York, maintains bank accounts in which receipts are deposited and from which disbursements are made, in the usual course of business, at Bank *A*, located in New York, and Bank *B*, located in Chicago. The general office procedure relating to cash disbursements requires, among other things, that invoices and payrolls be approved by the department heads concerned, and that checks be signed by the cashier and countersigned by the office manager. It is also the practice for the cashier to receive the monthly bank statements, reconcile the bank accounts, and turn over the bank statements, canceled checks, and other memoranda to the office manager, who checks the reconcilements. Protected paper is used on disbursement checks, and such checks are serially numbered.

On December 10, 1955, the general office cashier embezzles $5,000 from the company by drawing a check to his own order on Bank *A*, to which he successfully forges the office manager's countersignature. No entry of this disbursement is made in the cash book. On December 31, 1955, the cashier draws a check on Bank *B* for $5,000 to the order of Bank *A*, and obtains the office manager's countersignature by explaining that the check is in connection with a transfer of funds. The cashier deposits the second check in Bank *A* on December 31, 1955, but makes no cash book entries for the receipt in Bank *A* or the disbursement from Bank *B*. Upon receipt of the December bank statement from Bank *A*, the cashier destroys the check paid by that bank which he drew on December 10. The office manager, in checking the bank reconcilement, does not discover the embezzlement.

You are engaged to make an examination of Company *A*'s accounts for the year ended December 31, 1955, and begin your examination on the morning of January 18. (1) What type of defalcation does this case illustrate? (2) Specify and briefly describe three methods of verifying cash balances and transactions by which this type of defalcation should be detected. (AIA)

Problem 8–12. Explain how you would proceed to discover irregularities in cash payrolls when it is suspected that the following conditions exist: (1) Employees released have been continued on payrolls for one or more weeks beyond date of release. (2) Wages paid to casual labor through paymaster's cash fund have been reimbursed to paymaster twice—once by reimbursement of payments made out of the paymaster's cash fund and

again through the usual payroll channels. (3) Wages not claimed by employees have been misappropriated by the paymaster. (AIA)

Problem 8–13. In making an audit of a small business enterprise you find that all cash collections are received directly by the bookkeeper who keeps the general ledger and the customers ledger. There are two assistants in the accounting department who write up the cash purchases and sales records, and prepare customers' statements. The customers' statements are turned over to the bookkeeper, who looks them over before they are sent out. The bookkeeper has a small imprest fund, but to avoid more frequent replenishment of this fund he often cashes checks of employees or outsiders out of the cash collections. These checks are cashed with proper approval and deposited in lieu of the currency used to cash them. What effect will this situation have on your audit program? What recommendations would you make for improving the internal control? (AIA)

Problem 8–14. You are assigned to audit the Ajax Axe Company, a small one-man engagement, and you begin work January 6, 1955. This is the first audit of the Ajax Axe Company by your firm. Your preliminary review of the internal control discloses the following:

Office staff: four people
- Chief accountant and cashier: Amos Arnold
- Stenographer and accounts receivable bookkeeper: Betty Benedict
- Sales clerk and stockroom attendant: N. T. Drucker
- President and general manager: Ajax Cassinopolous

Cash sales are rung up on a visible cash register by Drucker as made. Once or twice a month he turns receipts over to Arnold for deposit. Cassinopolous always checks the cash register tapes against the cash book entry to make sure that all cash sales are entered. Deposits are made and bank reconciliations prepared by Arnold. Checks are signed by Arnold and must be countersigned by Cassinopolous who carefully reviews documents supporting the disbursement before singing. Occasionally, if ill or forced to leave town for a few days, Cassinopolous signs one or two checks in advance and leaves them with Arnold. Miss Benedict has no contact with cash. She posts to both the accounts receivable and accounts payable ledgers from the cash books which are kept by Arnold. She also sends out monthly statements to customers, opens all mail, giving checks to Arnold for deposit, and forwards correspondence to Cassinopolous. The following records and documents are reproduced here:

1. Cash receipts book for July and December 1954.
2. Cash disbursements book for July and December 1954, and for the first 15 days of January 1955.
3. Client's bank reconcilements as of July 31, November 30, and December 31, 1954.

4. Bank statements for July and December 1954 obtained from the client.
5. Special "cut-off" bank statement dated January 10, 1955, obtained directly from the bank.
6. General ledger Cash account for the entire year 1954.

Required: (1) A discussion of any weaknesses in the system of internal control as described. (2) Work papers showing the work you have performed in verifying the records as shown. (3) A summary of your findings suitable for review by your superior.

AJAX AXE COMPANY

CASH RECEIPTS BOOK—JULY 1954

Date	Received from	Cash	Sales Disc.	Cash Sales	Accts. Rec.	Miscellaneous	
July 2	Apex Supply Store	634.06	12.94		647.00		
5	Hardwick Hardware, Inc.	796.63	16.26		812.89		
6	Links & Locks, Inc.	1,902.18	38.82		1,941.00		
9	Smithfield and Rye	695.80	14.20		710.00		
14	Walker & Walker, Inc.	126.45			126.45		
16	Hi Grade Junk Co.	7.50				Misc. Inc.	7 50
16	Cash Sales	530.20		530.20			
19	Lewis Brands, Inc.	431.41			431.41		
20	Shott and Shott	2,599.30	53.05		2,652.35		
23	High and Wyde	979.90	20.00		999.90		
27	Smith Auto Supply	1,748.42	35.68		1,784.10		
28	Ace Retail Stores	3,331.80	78.20		3,410.00		
28	R. E. Lawrence, Inc	847.12			847.12		
30	Cash sales	721.20		721.20			
		15,051.97	369.15	1,051.40	14,362.22		7.50

CASH RECEIPTS BOOK—DECEMBER 1954

Date	Received from	Cash	Sales Disc.	Cash Sales	Accts. Rec.	Miscellaneous	
Dec. 1	Williamson Co.	441.00	9.00		450.00		
3	Hubbs and Dibbs	269.50	5.50		275.00		
3	Ace Retail Stores	364.00			364.00		
6	Smith Auto Supply	1,652.76	183.64		1,836.40		
9	Sundby and Son	465.79	9 51		475.30		
9	Walker & Walker, Inc.	312.64			312.64		
10	Fosdick Hardware Co.	1,834.56	37.44		1,872.00		
10	Fellows Hardware, Inc.	588.00	12.00			Notes Rec.	600.00
15	Cash sales	142.85		142.85			
24	Wolf Hardware Co.	2,548.00	52.00		2,600.00		
27	Apex Supply Stores	599.76	12.24		612.00		
28	Strate and Narrow	1,740.00			1,740.00		
29	Little Novelty Shop	3,998.40	81 60		4,080.00		
30	Lewis Brands, Inc.	267.30	2.70		270.00		
30	High and Wyde	390.00			390.00		
30	Cash sales	498.45		498.45			
		16,113.01	405.63	641.30	15,277.34		600.00

CASH DISBURSEMENTS BOOK—JULY 1954

Date	Paid to	Check No.	Cash	Purch. Disc.	Accts. Pay.	Miscellaneous	
July 2	Laughlin Forges, Inc.	1579	6,327.86	129.14	6,457.00		
5	Efficient Advertising Service	1580	248.75		248.75		
5	Wright Box Co.	1581	134.06	2.74	136.80		
7	Wheeler Supply Co.	1582	461.38	9.42	470.80		
15	Payroll	1583	3,945.10			Salaries and wages	3,945 10
20	Winters Cabinet Co.	1584	86.38		86.38		
23	Lamper Garage	1585	19.80		19.80		
27	Steel and Son	1586	825.43	16 85	842.28		
31	Payroll	1587	3,281 50			Salaries and wages	3,281.50
			15,530.26	158.15	8,261.81		7,426.60

CASH DISBURSEMENTS BOOK—DECEMBER 1954

Date	Paid to	Check No.	Cash	Purch. Disc.	Accts. Pay.	Miscellaneous	
Dec. 1	Winters Cabinet Co.	1641	2,360.00		2,360.00		
1	Lincoln Office Supply	1642	35.40			Office expense	35.40
2	Laughlin Forges, Inc	1643	7,762.00	158.00	7,920.00		
6	Wright Box Co.	1644	84 67	1.73	86.40		
6	Cash	1645	50.00			Office expense	50.00
7	Lester Paint & Supply	1646	270.77	5.53	276 30		
15	Payroll	1647	3,624 80			Salaries and wages	3,624 80
20	Loomis Woodworking Shop	1648	853.87	17.43	871.30		
28	Steel and Son	1649	894.54	18 26	912.80		
31	Payroll	1650	3,590 00			Salaries and wages	3,590.00
			19,526.05	200.95	12,426.80		7,300.20

CASH DISBURSEMENTS BOOK—JANUARY 1954

Date	Paid to	Check No.	Cash	Purch. Disc.	Accts. Pay.	Miscellaneous	
Jan 2	Lester Paint & Supply	1651	617.79	12.61	630.40		
2	Loomis Woodworking Shop	1652	208.25	4.25	212.50		
6	Wright Box Company	1653	226.50	4.60	231.10		
7	Wheat Grinding Corp.	1654	478.11		478.11		
14	Laughlin Forges, Inc.	1655	2,686.18	54.82	2,741.00		
15	Payroll	1656	3,345.11			Salaries and wages	3,345.11

General Ledger Account for Cash

Cash

1954				1954			
Jan. 1	Balance forward		10,743.12	Jan. 31	CDB		14,284.12
31	CRB	(12,890.12)	16,431.12	Feb. 28	CDB		15,789.98
Feb. 28	CRB	(15,349.87)	18,249.73	Mar. 31	CDB		13,411.12
Mar. 31	CRB	(14,585.86)	12,647.11	Apr. 30	CDB		14,842.11
Apr. 30	CRB	(13,992.67)	14,248.92	May 31	CDB		15,211.87
May 31	CRB	(15,024.61)	16,243.81	June 30	CDB		12,411.09
June 30	CRB	(16,285.36)	13,671.84	July 31	CDB		15,530.26
July 31	CRB	(15,807.07)	15,051.97	Aug. 31	CDB		12,997.62
Aug. 31	CRB	(17,529.56)	14,720.11	Sept. 30	CDB		14,311.90
Sept. 30	CRB	(18,829.80)	15,612.14	Oct. 31	CDB		14,611.12
Oct. 31	CRB	(21,486.66)	17,267.98	Nov. 30	CDB		17,240.32
Nov. 30	CRB	(17,657.45)	13,411.11	Dec. 31	CDB		19,526.05
Dec. 31	CRB	(13,244.41)	16,113.01	31	Balance forward		13,244.41
			194,411.97				194,411.97
1955							
Jan. 1	Balance forward		13,244.41				

Bank Reconcilements

July 31, 1954

Balance per bank statement		15,535.46
Less outstanding checks:		
#1401	894.30	
1584	86.38	
1585	19.80	
1586	825.43	1,825.91
		13,709.55
Add deposit in transit		2,097.52
Balance per books		15,807.07

November 30, 1954

Balance per bank statement		17,080.64
Less outstanding checks:		
#1632	212.40	
1635	1,000.00	
1636	611.10	
1639	12.40	1,835.90
		15,244.74
Add deposit in transit		2,412.71
Balance per books		17,657.45

December 31, 1954

Balance per bank statement		13,578.92
Less outstanding checks:		
#1648	853.87	
1649	894.54	1,648.41
		11,930.51
Add deposit in transit		1,298.60
		13,229.11
Add bank service charge		15.30
Balance per books		13,244.41

Note: No bank reconcilement was prepared for June 30, 1954, as Mr. Arnold was on vacation.

Bank Statements

Wakefield Bank and Trust Co.
Wakefield, Illinois

July 1954 In account with Ajax Axe Co.

	Checks			Deposits	Balance
			7/1		17,739.71
425.10	11.16	123.79	7/4	4,028.67	21,208.33
6,327.86	248.75	134.06	7/16		14,497.66
461.38	3,945.10		7/21	2,965.66	13,056.84
3,281.50			7/29	5,760.12	15,535.46
			7/31		15,535.46

WAKEFIELD BANK AND TRUST CO.
WAKEFIELD, ILLINOIS

December 1954 In account with Ajax Axe Co.

Checks					Deposits	Balance
				12/1		17,080.64
				12/1	2,412.71	19,493.35
212.40	1,000.00	2,360.00		12/5	1,074.50	16,995.45
35.40	611.10	12.40	7,762.00	12/12	4,353.75	12,928.30
84.67	50.00	270.77		12/25	2,248.00	14,770.86
3,624.80	15.30	(SC)				11,130.76
3,590.00				12/31	6,038.16	13,578.92

WAKEFIELD BANK AND TRUST CO.
WAKEFIELD, ILLINOIS

January 1955 In account with Ajax Axe Co.

Checks				Deposits	Balance
			1/1		13,578.92
894.54	208.25	617.79	1/5	1,298.60	13,156.94
324.50	853.87	226.50	1/10	3,247.18	14,999.25

Chapter 9

VERIFICATION OF RECEIVABLES AND SALES TRANSACTIONS

The term "receivables" is used broadly to include almost all amounts receivable by a concern from its customers, employees, officers, branches, and affiliated or subsidiary concerns, except those which are evidenced by a bond or other security. From the verification point of view they can be divided into three classes:

1. Accounts receivable from customers.
2. Notes receivable.
3. Other receivables.

ACCOUNTS RECEIVABLE FROM CUSTOMERS

Accounts receivable from customers are so closely related to sales transactions that any consideration of one must almost necessarily include the other. Certainly any verification of accounts receivable which neglects a reasonable test of the sales transactions must be considered incomplete.

Not only must sales transactions, including sales returns and allowances, be considered with accounts receivable, but also any reserve or other provisions for uncollectible accounts must be examined together with its related expense account. Thus we have a group of related accounts that should be grouped for verification purposes and unless the audit program established includes some provision for examining each, it can hardly be considered adequate.

Because of the emphasis upon balance sheet accounts in the development of audit techniques and procedures, an audit program for this group of accounts commonly begins with accounts receivable. This, however, is not essential and the program could well be built around sales transactions.

Purpose of Verification of Receivables. As with cash and cash transactions, it is desirable to have a sound understanding of the reasons

for examining the balances of receivables and the details of sales transactions in order that no pertinent information will be overlooked during the course of the investigation. The following should probably be considered as the chief purposes for this phase of the verification program.

1. To determine whether the balance sheet or general ledger amount for receivables is supported by valid accounts.
2. To determine whether the receivables as stated are collectible.
3. To determine whether the receivables are properly classified and described.
4. To determine whether sales transactions have been accounted for properly during the period.

Contrary to the situation in regard to cash, the various verification procedures applied to receivables and sales transactions do not tie in directly with these purposes. Each procedure appears to touch on more than one purpose, and it is therefore essential that the auditor be constantly alert to the implications of information which he uncovers during his examination. For example, in discussing the collectibility of a certain account balance with one of the company officers, an auditor may learn that the company does a consignment business with that customer and with other customers. He must be careful then to follow up this information to discover whether consignment amounts are incorrectly included as ordinary trade receivables. In such a transaction there is the further suggestion that the inventory amount may likewise be in error, but that is a matter which must wait until the subject of inventory verification is discussed.

Audit Program for Accounts Receivable and Sales Transactions. As a help in understanding the purpose of specific verification procedures, it should be noted that, in the following suggested procedure, again there is a separation into what might be called primary and supporting procedures. Often the supporting procedures are equally as important as the primary steps, for if they were omitted the primary verification would be of little value. The subclassification, therefore, is not intended to indicate relative importance; it is intended only to show the relationship of one procedure to another. With only one or two minor exceptions, these procedures are applicable to a business which sells either commodities or services on account.

1. Obtain a detailed list of the receivables (aged if possible), compare with the subsidiary ledger accounts, foot, and agree total with control account or balance sheet amount.

2. Obtain independent verification of balances.
   A. Send confirmation requests to a representative portion of the accounts, as described in Chapter 3.
   B. Obtain satisfactory explanations for any confirmations returned with exceptions or differences.
   C. Investigate the propriety of any accounts for which confirmations were requested and not returned.
3. Consider collectibility of account balances.
   A. Review accounts with credit manager or other official giving special attention to large or overdue balances.
   B. Insure that Reserve for Bad Debts is adequate to cover all uncollectible accounts plus a reasonable provision for doubtful accounts. (If no reserve is used, all uncollectible and seriously doubtful accounts should be written off.)
      (*a*) Inquire into authority for accounts written off as uncollectible during the period under examination.
4. Test arithmetical accuracy of accounts.
   A. Foot and balance ledger accounts for receivables.
   B. Test postings to books of original entry.
   C. Investigate propriety of any unusual entries in the Accounts Receivable controlling accounts.
   D. Test a portion of the detail ledger by tracing entries in the accounts back to the books of original entry.
5. Verify sales transactions for a test period.
   A. Compare duplicate sales invoices with entries in sales book.
   B. Foot sales book.
   C. Trace postings to general ledger accounts.
   D. Examine documentary evidence supporting sales returns and sales allowance transactions. (If a special book of original entry is used to record such transactions, it should be tested to the same extent and in the same way as the sales book. If no such book is used, then the propriety of the entries and their subsequent posting must be verified individually as the circumstances warrant.)
   E. Account for all sales invoices and for all credit memos issued for the test period.
   F. Foot and balance the Sales account.
   G. Investigate propriety of any unusual entries in the Sales account.
6. Determine whether sales book has been held open past the closing date by comparing invoice dates and shipping dates for last sales of the period with the dates of entry in the sales record.

7. Determine whether the cash receipts book has been held open past the closing date by comparing date of entry with date of deposit for last cash receipts of the period.
8. Prepare any necessary adjusting or reclassifying journal entries.

A brief discussion of the important points to be remembered in applying each of the above procedures will be presented in the following paragraphs together with an explanation of the purpose of the procedure.

Detailed List of Accounts Receivable. The purpose of preparing a detailed trial balance of the accounts receivable ledger is to make sure that the controlling account or the balance sheet amount, as the case may be, is supported by individual accounts receivable, and that the total agrees with the sum of the individual balances. To do this it is essential that the auditor compare the amounts on the trial balance with the individual account balances. This does not mean that he must prepare the list himself. Taking a trial balance of a subsidiary ledger is a clerical task which he should avoid if possible. If the company prepares such a trial balance in the normal course of its accounting routine, he should request that they prepare an extra copy for him which he can use and include with his work papers. He cannot, however, rely on such a list until he has checked it back, item by item, against the subsidiary ledger from which it was taken.

Likewise, if the company has aged the accounts in the trial balance, an auditor should take advantage of the aging schedule if he can obtain a copy. Again, however, he should not rely on it unless he has tested it by working out the aging on a sample of the accounts and found that the company employees have performed the aging work accurately. The use of an aged trial balance is discussed at greater length in the discussion of collectibility of accounts receivable later in this chapter.

In those cases in which the subsidiary ledger and the control account are not in agreement, an adjustment must be made to bring the two together. In most cases this adjustment should not be made until all other verification steps have been completed as it is entirely possible that some of the other procedures will locate the error or errors causing the difficulty or may even uncover additional differences. It will be evident that most of the verification work on accounts receivable is directed at the individual accounts, and that, in so far as the records are concerned, they are more likely to be accurate than the control. This is because customers will complain if they receive monthly statements giving a balance different from the one they consider correct, whereas no outsider

is in a position to know whether the control account balance is wrong. Hence, in adjusting any difference between subsidiary ledger and control, it is customary to bring the control account into agreement with the subsidiary ledger unless there is definite evidence that the subsidiary ledger is the one at fault.

Independent Verification of Accounts Receivable. The heart of the verification procedure for accounts receivable lies in the confirmation technique. The general requirements of the confirmation procedure are discussed in Chapter 3 and need no elaboration at this point. It should be remembered, however, that at no point in the verification of receivables is care and alertness required more than in their confirmation. One means of covering up shortages of cash or of window-dressing a balance sheet is through manipulation of the accounts receivable, and an auditor must be continually on the alert for such possibilities.

Types of Confirmation. Two methods of confirmation are in common use; these are known as the "positive" and the "negative" methods. A positive confirmation consists of a request by the company under examination, calling on its customer to reply directly to the auditor and to inform him of the accuracy of the company's statement of the customer's account balance. It may consist of a printed form, generally divided into two parts, the first of which is a brief communication from the company to the customer requesting him to communicate with the auditor, and the second a communication from the customer to the auditor requiring only the customer's signature for completion if the balance is correct. Sometimes instead of a printed form a letter is drafted to the customer which merely requires his signature at the bottom before return to the auditor. A stamped envelope addressed to the auditor is always included with a positive-type confirmation.

Negative confirmations do not require an answer by the customer unless the account balance as stated is incorrect. Negative confirmations are generally sent out with the regular monthly statement to the customer and take the form of either a rubber stamp impression on the monthly statement or a gummed sticker attached to it with wording somewhat as follows:

> Please examine the attached statement of your account carefully. If the balance shown is incorrect, please communicate directly with our auditors, Wake and Field, Certified Public Accountants, Budget Building, Chicago, Illinois.

Dear Sirs:

Will you please advise our auditors, Elmon & Arden, Certified Public Accountants, on the attached form, of the correctness of the balance in your account as shown by our books at the date and in the amount stated below, or of any exceptions you may take thereto. A stamped and addressed envelope for your reply is enclosed.

____

To

(This is merely a request for confirmation, not for remittance.)

Messrs. Elmon & Arden
2400 Tower Building No.__________
Chicago, Illinois

We (I) confirm the correctness of a debit balance of $__________ in our (my) account on the books of____________________________ as of__________________19_____, with the exceptions, if any, stated below.

Signed____________________

By____________________

Exceptions
(please explain differences in detail giving dates and amounts)

____

____

____

____

(Use other side if necessary.)

Illustration 12. Accounts receivable confirmation form—positive.

The weakness in a negative-type confirmation is that if the confirmation is not returned there is still a question whether the account balance is correct or whether the customer merely ignored it. The auditor has no real proof that the account balance is as stated. A positive confirmation, however, does give the auditor real evidence that the customer accepts the account balance as stated, evidence that can be included in the work papers for future reference.

Accounts receivable are seldom confirmed completely. This test like other audit procedures is generally applied on a sample basis with the theory that, if the sample is a fair one and if no errors are found in the sample, then probably no material errors exist in the accounts not tested either. To confirm a representative proportion requires that some of the large account balances as well as some of the small ones be selected. Also that, if there are both city and country accounts, or if there is subdivision of the accounts receivable ledger on any basis whatever, accounts should be selected from each division. If there are accounts with credit balances, a very common situation, it is well to include some of them as well in order to discover any tendency to understate the liability that such accounts represent.

It is impossible to give any blanket rule indicating the number or percentage of accounts to be confirmed. One point should not be overlooked, however. If care is taken in selecting the accounts to be confirmed, it is frequently possible to get a very high dollar amount of accounts with a relatively small total number of confirmations. Most companies will have a relatively small number of large account balances and a very large number of small account balances. By selecting as many as possible of the larger accounts it is often possible to get as high as an 80 per cent or higher proportion of the total dollar amount of receivables confirmed with a small number of confirmations.

If at all possible, positive-type confirmations should be used for the large account balances and it is desirable that they be used also for at least some of the smaller balances. Negative-type confirmations should be used only when, because of the large size of the sample to be confirmed, the positive type is not practicable. For example, a public utility will normally have a great number of small account balances; so will a department store. Each of these will also have a smaller number of large account balances. Positive confirmations should be used for the larger balances, and then, if it is desirable to make an extensive test of the small accounts, negative-type confirmations might be employed for that purpose. Complete reliance on negative confirmation requests is seldom justified.

Clement Company
Accounts Receivable Confirmations
12/31/54

Page 4 of 4

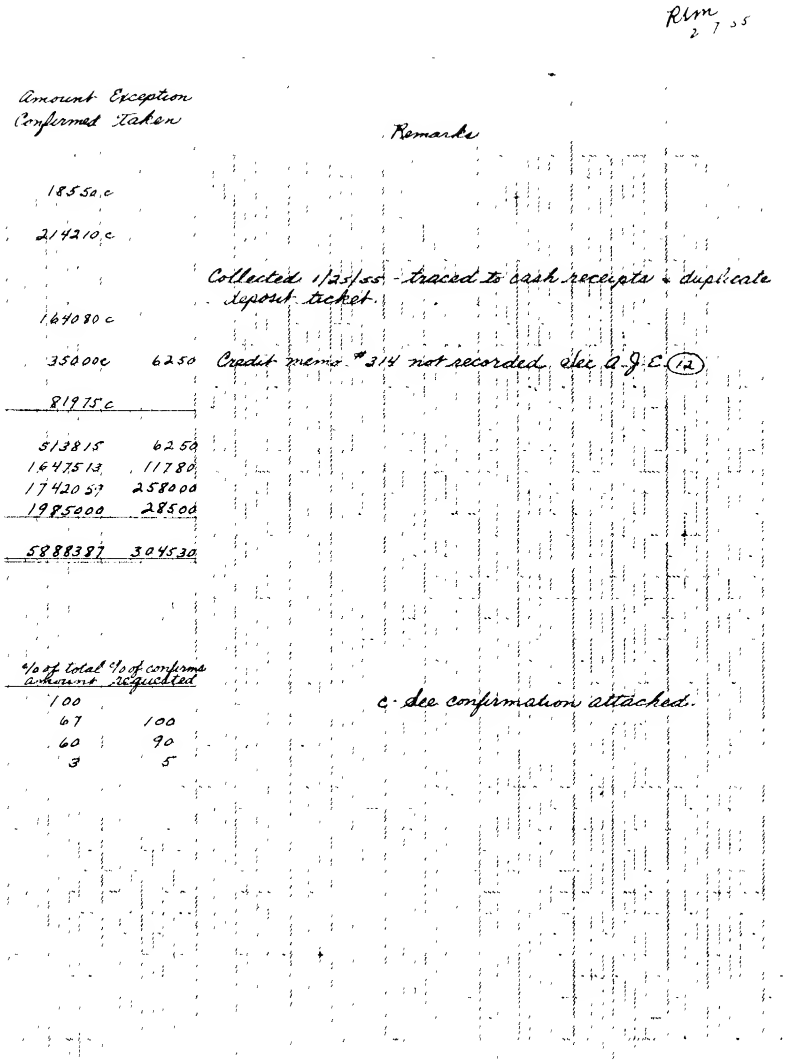
Customer	Address	Confirm No	Account Balance 12/31/54
General Food Stores	1 N Main, Champaign	76	18550
Jemisons Service Station	Third & John, Urbana	77	214210
Wrights Vending Service	2917 S Neil, Champaign	78	38475
Downtown Pharmacy	214 N First, Urbana	79	164080
Kelly's Drive-In	1810 Washington, Champaign	80	41200
E + F Cafe	256 Main, Champaign	81	81975
Total this page			558490
" page 1			1191285
" " 2			2161488
" " 3			2040010
			6551273

Summary of Confirmation Results

	Number	Amount
Total customer's accounts	285	9847516
Confirms requested	81	6551273
Confirms received O.K.	58	5888387
Exceptions taken	7	304530
Exceptions cleared	3	181050
Adjustment required	4	123480
Confirms not returned	16	358356

Illustration 13. Work sheet for

Work Sheet Record of Confirmations. Some method must be used to maintain control over the confirmation requests sent and the replies received. Various work sheet forms are used for this purpose. Sometimes the trial balance of the subsidiary ledger allows sufficient space for including information as to the confirmations sent and returned; in other


Rlm 2/7/55

Amount Confirmed	Exception Taken	Remarks
18550 c		
214210 c		
		Collected 1/25/55 - traced to cash receipts & duplicate deposit ticket.
164080 c		
35000 c	6250	Credit memo #314 not recorded. See A.J.E. (12)
81975 c		
513815	6250	
1647513	11780	
1742057	258000	
1985000	28500	
5888387	304530	

% of total amount	% of confirms requested
100	
67	100
60	90
3	5

c - see confirmation attached.

accounts receivable confirmations.

cases a separate work sheet is desirable. At least the following should be provided for:

Customer's name.
Customer's address.
Confirmation number.

Account balance confirmed.
Confirmations returned without exception.
Confirmations returned with exceptions.
Exceptions cleared.
Exceptions not cleared.
Comments.

Confirmations Returned with Exceptions. Once confirmation requests have been mailed, some time must elapse before a sufficient number of them have been returned for the auditor to give them his attention again. He cannot expect company employees to discuss individual confirmations with him as they are returned, so he must wait until a group of them accumulates. Within a group of returned confirmations, a variety of replies will be found. Some will have no more than the customer's signature added, thus indicating that the account balance is correct. Others will contain comments of one kind or another indicating that the customer does not agree with the amount of his account as stated. In some cases this disagreement will be only an apparent disagreement because the customer did not read carefully enough the date of the confirmation request. Sometimes an unavoidable time lag between the time the customer mailed his check and the date on which the company gave him credit will account for the difference. In still other instances, the difference will be genuine.

For all genuine differences or exceptions, the auditor must obtain an explanation that either satisfies him that the account balance as stated is correct or else that the account balance is in error and must be corrected. The general practice is to discuss all confirmations containing genuine exceptions with the company employee best qualified to explain them. As explanations are given, the auditor must examine them critically and refuse to accept them until he is convinced of their validity. Each explanation finally accepted must, of course, be included in the work papers. One common practice is to write the explanation accepted by the auditor on the reverse side of the confirmation itself, so that the two are permanently associated for easy reference.

Confirmations Requested and Not Returned. Of the confirmation requests mailed, it is almost certain that some will not be returned. Failure of a customer to reply to a request for confirmation of his account balance raises the question whether he is merely uncooperative or whether perhaps the account is not a real one. This latter possibility requires that further investigation be carried out by the auditor. In some

cases, second requests for confirmation are mailed before other steps are undertaken.

If the confirmation procedure failed to give him satisfactory evidence of the reliability of the account balance, the auditor must seek for some other evidence that the account is a real one and that the balance is correct. If the account shows that cash has been received since the date of confirmation, that fact is reasonable evidence that the account is at least genuine, although not necessarily correct in amount, and if the auditor is certain of the receipt of cash he may accept that as sufficient evidence. To assure himself that the cash was actually received and not merely entered in the account with intent to make the account appear active, he may find it necessary to trace the cash receipt into a duplicate deposit ticket or at least into the cash receipts record.

If insufficient time has elapsed for remittances to have been received or if further evidence of the propriety of the account is desired, the charge to the account may be traced back to the duplicate sales invoice and to shipping documents. The existence of a sales invoice supported by shipping documents again is reasonable evidence that the account is based upon a legitimate transaction.

It should be emphasized that, unless the confirmation procedure is supported by adequate investigation of confirmation requests not answered and of accounts for which the confirmation indicates a difference, the confirmation procedure cannot be considered to have been employed satisfactorily.

Time of Confirming. It is desirable but not at all necessary to confirm accounts receivable at the end of the period under examination. The advantages of confirming at the end of the year are obvious, but there are disadvantages as well. The chief disadvantage is that the bulk of the verification work must wait until after the end of the year and that, if there is any need to complete the examination by a certain stipulated date, insufficient time may be allowed to investigate differences or confirmations not returned. There is the further possibility that inadequate time may be given to permit all confirmations to be returned. Hence it has become acceptable practice to apply the confirmation procedure at dates other than the year end.

A satisfactory procedure is to select a month-end date prior to the end of the year and use that as the confirmation date. If, for example, the company is on a calendar-year basis with the closing date as December 31, either October 31 or November 30 might serve as an accounts receivable confirmation date. This allows sufficient time for confirma-

tions to return and for any additional investigation to be completed before the year-end rush begins.

The practice of confirming at dates other than the year end relies to some extent on a system of internal control which is considered to be satisfactory. If the accounts are in good order at November 30 and if the internal control in effect is adequate, it then becomes a fair conclusion that the accounts will be reasonably accurate at December 31. But it is not necessary to rely completely on the internal control for the intervening transactions. If there is any real danger of errors in accounting for transactions during the month of December, the transactions for that month can be verified in detail, or tested, or merely reviewed in total as seems desirable.

Collectibility of Accounts Receivable. The basis for a review of the collectibility of the accounts receivable is a schedule showing the age of each account balance. With this before him, an auditor can readily pick out the balances past due and any unsettled invoices which the customer evidently has no intention of paying. All such items should be brought to the attention of someone on the company's staff who is qualified to discuss them. Generally this will be a representative of the credit and collection department or of the treasurer's department. Satisfactory explanations must be obtained for all the overdue amounts. If it appears that the account is definitely uncollectible it must be written off or provided for in the Reserve for Bad Debts. If it appears doubtful of collection, some increase in the reserve appears warranted.

The close relationship of the Reserve for Bad Debts to the Accounts Receivable balance is apparent. It should also be apparent that there is nothing fixed about such a relationship. After reviewing the accounts in detail, the auditor must then evaluate the adequacy of the reserve provided by the company. If it appears either too generous or too small, adjustment is in order. On the other hand, the company officials should be permitted reasonable latitude in establishing what they consider to be an appropriate allowance for uncollectibles. All that an auditor is expected to do in most situations is to review the reasonableness of their provision.

If the company does not make use of a Reserve for Bad Debts account, the auditor must be somewhat more strict in requiring that uncollectible and doubtful accounts be removed from Accounts Receivable. This does not mean that they must be written off as lost. They should, however, be clearly described and segregated from the regular receivables.

At the same time that he is reviewing the adequacy of the Reserve for Doubtful Accounts, the authority for any accounts written off during the period should be investigated. Internal control requires that someone not directly connected with the accounts receivable approve their write-off as uncollectible in order that employees who have pilfered amounts collected from customers will not be able to cover their peculations by writing the accounts off as uncollectible, and thus clearing the balance so the customer will not complain at receiving a statement. An auditor should make sure that any accounts written off have been properly approved as provided for by the internal control provisions in effect. If no such provisions exist, he should call for correspondence, for reports of the credit and collection department, or for any other evidence available that indicates the account was written off only after every effort had been made at collection. If no evidence of that nature is available, the situation should be reported to the company officials.

If the company uses the reserve method of accounting for bad debts, it should be an easy matter to prove the balance of Bad Debts Expense for the year as that amount should agree with the additions to the reserve. If no reserve is used, the accounts written off make up the expense for the period. In either case, the auditor should analyze the balance of the expense account and satisfy himself that it is correct in connection with his work on Accounts Receivable.

Arithmetical Accuracy of Controlling Account. To eliminate the possibility of a forced balance, the general ledger controlling account for accounts receivable should be footed and balanced, and the entries in the account traced back to the books of original entry. The last of these steps may be reduced to a test of only a few months, but it is desirable to discover whether entries in the account do actually come from the appropriate books of original entry.

A controlling account for receivables that receives its postings from columnar books of original entry should have no more than twelve entries a year from the sales book and twelve credits a year from the cash receipts book. More entries or entries from other sources are unusual enough to warrant investigation. They should be traced back to their source, the original documents examined, and inquiry made of company employees as to the reason for such entries. An advance to a subsidiary company, for example, might be entered as a debit to Accounts Receivable and a credit to Cash. An alert auditor would note the debit in the Accounts Receivable control account from the cash disbursements book as the posting reference, and would at once

be curious as to the reason for the entry. This would lead to discovery of the nature of the transaction, and reclassification of the receivable as an amount due from a subsidiary company would follow.

Test of Accounts Receivable Ledger. The extent of the confirmation procedure applied to the accounts receivable ledger tends to govern the amount of detail testing of the entries in that ledger. If the confirmation sample was extensive and the returns and supporting investigations satisfactory, little attention need be given to the subsidiary ledger. If, on the other hand, only a small sample was confirmed or if confirmation was omitted completely, substantial tests of the detailed ledger would be indicated.

Testing the detailed ledger consists of tracing the entries in that ledger back to their original sources. Debits should be followed back through the sales record to duplicate sales tickets; credits to the cash receipts book and remittance advices; or to credit memorandums. In doing this it is important that the tracing go from the ledger back to the documents. A group of accounts should be selected, and all transactions in those accounts for a given period traced back in order to ascertain that the accounts have valid support.

Verification of Sales Transactions. The verification of any transaction requires both examination of the document that evidences the transaction and review of the entry made in light of the facts indicated in the document. The original document for sales transactions would be the original sales invoices, but in most cases original sales invoices will have been mailed to the customer and will not be available for examination. Reliance must therefore be on the duplicate copies of sales invoices retained by the company. These should be examined and compared with entries in the sales record. Any questionable items, such as large sales made immediately prior to the end of the period, might be further investigated by reference to shipping documents, sales orders, or correspondence.

The sales book must, of course, be footed, and postings to the general ledger traced. For the period of the test, the numerical integrity of the sales invoices entered must be determined to discover whether transactions were omitted either deliberately or inadvertently. In some cases the entry in the sales record is merely a daily summary, and the sales invoices themselves must be footed and their numbers carefully checked to make sure that none has been omitted.

The same attention must be given to sales returns and allowances as is given to sales transactions. In both cases special attention should be given to the matter of approvals and authorization of the transaction. The need for this is apparent with returns and allowances which may be used as a means of covering a credit for intercepted receipts from customers. It is no less important for sales transactions, which should be approved as to credit before shipment to avoid unnecessary losses on uncollectible accounts resulting from poor credit risks.

The Sales account must be footed, the balance proved, and any unusual transactions investigated. It should be remembered that the Sales account is commonly the account with the largest balance in the entire general ledger. Anyone with a transaction to "bury" tends to look for those accounts whose balance is large enough to absorb the item in question without any material distortion. The Sales account, Purchases, and a few of the larger expenses have balances sufficiently large for this purpose, and, of course, are sometimes used in this way. If there are any entries in the Sales account other than from the sales record, the auditor should trace them back to their source and find out their nature. If they are of material amount and foreign to the operation of the Sales account he should require reclassification.

Sales or Cash Book Held Open. Some companies follow the improper practice of holding their sales and cash receipts books open past the end of the fiscal period. That is, they enter transactions of the next period as if they happened within the period under examination. Assume, for example, a company with a business year ending June 30. It might hold open its sales book so that sales made July 1, 2, 3, and even later are entered under date of June 30. This has the advantage of increasing both receivables and sales for the period, and thus improving both the income statement and the balance sheet. If the physical inventory was taken on June 30, merchandise included in the inventory on June 30 would be included in the balance sheet on that date. If the sales book is held open, an account receivable resulting from the sale of some of that same merchandise might appear in the same balance sheet.

The same practice of entering July transactions under a June date might be followed with regard to the cash receipts book. This results in a reduction of receivables and an increase in cash with no effect on the income for the period. It does improve the current position of the company somewhat.

Such a practice is incorrect because it fails to include transactions within the correct period, and because it misstates the balance sheet

and income statement. To determine whether the company is holding its sales and cash records open and to determine the extent of the error if any has been made, the following tests are useful:

1. For the last five days of the period under examination and the first five days of the following period, compare the sales invoice date, the shipping date as shown by shipping documents, and the date of entry for all sales invoices of material amount.
2. For the same period, compare cash receipts per books with deposits per bank statements.

If the company has entered transactions on an incorrect date, these tests should so indicate. They can be expanded to cover a longer period if necessary but are generally restricted to a short period unless it is discovered that the improper practice is being followed.

It should be apparent that if sales invoices have been entered in the wrong period a problem of an incorrect inventory amount is present. This is discussed in more detail in connection with the verification of inventories in Chapter 10.

NOTES RECEIVABLE

In so far as verification is concerned, notes receivable usually differ from accounts receivable in but two respects. First, the note itself, barring forgery, is documentary evidence of its own existence, whereas an account receivable does not constitute such evidence; second, most concerns have very few notes receivable in proportion to their accounts receivable. That is, in most types of credit business, note receivable transactions are few, whereas account receivable transactions make up the majority of sales.

The fact that notes receivable are on hand and can be examined by an auditor adds that verification step to the audit program. It does not eliminate the other important steps of confirmation, review of collectibility, and the like. There is always the possibility that an apparently valid note is a forgery, or that partial payments have been received and not recorded. Hence confirmation must apply to notes as well as to accounts receivable. In reviewing the collectibility of notes, care must be taken not to be misled by the date of the note. A note of recent date may have been received on an overdue account and actually be no more collectible than the account. It is therefore important to determine the transaction on which the note receivable is actually based before attempting to evaluate collectibility.

Although most concerns receive relatively few notes, some find that notes receivable make up a major part of their operations. Small loan companies, building and loan associations, companies that discount notes received in automobile or electric appliance sales, and others tend to have notes receivable where other companies have accounts receivable. Where such a situation exists, the verification procedure discussed previously for accounts receivable should be applied with the addition of a provision for examining a sample of the notes as well as the security supporting the notes, if practicable. For the majority of companies, those with but a few note transactions, the program discussed in the following section, which includes verification of all note transactions, should be followed.

Essentials of Verification for Notes Receivable. Because note receivable transactions are somewhat unusual and therefore less likely to be adequately covered by internal control provisions than accounts receivable transactions, and because they are generally few in number, it is recommended that all notes be confirmed and all transactions verified in so far as practicable. There is the further problem that notes receivable frequently give rise to interest income, another miscellaneous source of cash, and this requires that care be exercised to assure that interest collections have been properly accounted for and deposited to the credit of the company. With the exception of these additions and the examination of the notes themselves, there is little difference between the suggested verification program for accounts receivable and that for notes receivable. A program for notes receivable follows:

1. Obtain or prepare a detailed list of the notes, foot, and agree with controlling account.
2. Examine the notes for propriety and authenticity.
3. Examine security, supporting agreements, or endorsements, in so far as appears necessary and practicable.
4. Confirm all notes of material amount including such pertinent details as interest rates and dates, date interest last paid, maturity date.
5. Foot general ledger account and prove balance.
   A. Investigate any unusual entries in the account, especially non-cash credits.
6. Trace payments received during the period into the cash receipts book and into duplicate deposit tickets.
7. Review notes for collectibility.

7. Determine nature and date of transaction out of which note came before passing any notes as current.
8. Compute accrued interest and interest earned, and tie in with the Interest Income account.

Little additional explanation is required for any of the steps listed unless perhaps for the last one, that of computing the accrued interest

Anderson Company
Notes Receivable
December 31, 1954

Maker	Date Received	Term	Due Date	Rate	Balance 12/31/53
Steen and Son	3/31/52	3 yrs	3/31/55	4%	800.00 ✓
Sundby and Sundby	1/5/53	1 yr	1/15/54	6%	1,000.00 ✓
Carl Company	7/1/53	2 yr	7/1/55	6%	400.00 ✓
Kristen, Incorporated	9/30/54	6 mos	3/31/55	5%	
Local Supply Co	12/1/54	1 yr.	12/1/55	4%	
					2,200.00

Illustration 14. Notes

and agreeing it with the general ledger accounts for interest accrued and interest income. The interest earned on notes receivable during the period may not be the only interest earned by a company during the period under examination, and unless the general ledger contains a special account for interest on notes receivable a direct agreement of the interest earned as computed by the auditor and the balance of the

RAM
2-7-55

Notes Receivable			Interest			
Notes Received	Collections Received	Balance 12/31/54	Interest Accrued 12/31/53	Interest Earned	Interest Collected	Interest Accrued 12/31/54
		800.00 n c	8.00 ✓	32.00 x	32.00 ✗	8.00 x
	1000.00 ✗	-0-	57.50 ✓	2.50 x	60.00 ✗	-0-
		400.00 n c	12.00 ✓	24.00 x		36.00 x
750.00		750.00 n c		9.38 x		9.38 x
600.00		600.00 n c		2.00 x		2.00 x
1350.00	1000.00	2550.00	77.50	69.88	92.00	55.38
		T.B.				
Interest on investments - Anal. (9)				300.00		50.00
				369.88		105.38
				T.B		T.B.

✓ See our 12/31/53 work papers

✗ Traced to cash receipts book

n Note examined

c See confirmation attached

x O.K. per our computation

(7).

receivable work sheet.

Interest Income account may be impossible. In such a case it may be necessary to wait until the verification work is completed on other phases of the examination, such as that on securities, and the interest earned in other transactions is computed, before reconciliation to the balance of the Interest Income account is possible. Until such reconciliation is obtained, however, the verification of note transactions is not complete.

Work Sheet for Verification of Notes Receivable. Unless a company does have a large number of note transactions, all the verification work related to the notes receivable at the audit date and to the note transactions during the year can be brought into one comprehensive work sheet. This has advantages from the standpoint of verification as well as of review, and should be done whenever possible. The work paper shown in Illustration 14 indicates how this might be done. Note especially the use of tick marks to indicate the work done by the auditor and the explanation of all tick marks used on the work sheet. The tie-in of the work sheet with the general ledger trial balance is also indicated.

This particular style of work sheet should be considered as a basic one, flexible enough to be varied with the circumstances. For example, if the company has received notes receivable from its customers which they in turn had received from others, the notes would already have accrued interest on them when received. This suggests that an additional column could be inserted between the interest column "Interest Accrued 12/31/53" and "Interest Earned" to show the interest purchased when the note was received. As another example of how this work sheet might be varied, a situation in which notes receivable were discounted with a bank or other financial institution might require a column for discounted notes as well as for notes on hand at the year end. This would be particularly helpful in indicating the contingent liability on discounted notes.

It will be found that this same basic style of work sheet is useful for investments in stocks and bonds, for notes payable, and for unexpired insurance.

OTHER RECEIVABLES

Many companies have additional receivables varying considerably in amount and nature. Advances to salesmen and other employees, loans to officers, advances to affiliated and subsidiary companies, advances to airlines and to other suppliers, and advance payments on special contracts are all common. No set procedure can be given for verifica-

tion of such assets, but it should be clear that the most useful means of verifying receivables is the confirmation technique which should be used wherever applicable. To the extent necessary and possible it should be supported by discussions of collectibility with company officials, and by examination of correspondence, agreements, and the like. Care should also be exercised to insure that such receivables are properly described in both the work papers and the company's financial statements.

Basic Verification Techniques Applied in the Examination of Receivables and Sales Transactions. Although not generally considered to be an intangible asset in the accounting sense of that term, customers' accounts are of such nature that they cannot be examined physically. Therefore they are not verifiable by physical examination and count. Notes receivable are by definition written promises by the debtor and differ from accounts receivable in that they are subject to physical examination. However, the dangers of forged or otherwise fraudulent notes receivable are such that physical examination of notes is not completely satisfactory evidence. For these reasons and because of the importance of customers' accounts to the majority of companies, it is essential that a technique supplying evidence equally reliable be found applicable. As indicated in the discussions throughout this chapter, confirmation appears to meet the needs of the situation fully.

If confirmation requests are appropriately controlled, replies to them constitute reasonably satisfactory evidence of the validity of amounts shown in the company's records as receivable from customers. This is true for amounts receivable on notes as well as on open accounts.

In addition to confirmation, other techniques are useful. The examination of transactions almost always calls for reference to the underlying documents, and sales transactions are no exception. As the original sales invoices are generally forwarded to customers they are unavailable for examination by the auditor and he may find it necessary to rely on carbon or other duplicate copies. If these are properly supported by shipping documents and customers' orders they may be equally satisfactory.

Recomputation and the retracing of bookkeeping procedures are necessary to verify the total accounts receivable amount. Inquiry is particularly useful in investigating the collectibility and classification of receivables. In those special cases in which a relatively immaterial total amount is involved, as is not infrequent with employees' or similar receivables, examination of subsidiary records may be found sufficient in

itself. Scanning will, of course, be utilized in reviewing the controlling account and the subsidiary ledger accounts for unusual entries.

Accounts receivable and sales transactions together constitute one of the major audit problems in most situations, so it is not surprising to find all applicable techniques used. It is interesting, however, to find that a satisfactory verification program can be developed although one of the strongest techniques, physical examination and count, is not applicable.

PROBLEMS—CHAPTER 9

Problem 9–1. (*a*) Accepted auditing procedure requires the confirmation of receivables where such confirmation is practicable and reasonable. Under what conditions would you consider it to be impracticable to confirm receivables? (*b*) Where the accounts receivable are a material item among the assets, but the client refuses to permit the auditor to confirm them, what alternative procedures would you take and what in addition to using the alternative procedures might the auditor do, assuming he is making a regular annual audit and issuing a short-form report (certificate)? (*c*) Where there is a large number of receivables, a test circularization is frequently relied on by the auditor. You are to state the factors which the auditor should consider in selecting the individual items to be circularized. Assume that the general extent of the test has been determined. (AIA)

Problem 9–2. For several years you have been making the annual audit of a manufacturing company as of December 31. In order to spread out your work as much as is feasible, you have decided to do as much interim work as can profitably be done on this engagement, starting about two months before the year end. (*a*) You are to prepare an audit program in detail for preliminary work to be done in November on accounts receivable and sales. (*b*) You are to prepare a program in detail for the year-end examination of accounts receivable and sales, taking into account the work done in the preliminary examination. Prepare your programs taking into consideration the procedures and controls described below. Your files reveal the following information:

All sales are charged to Accounts Receivable, any cash collected before or at the time of sale being credited to the customer's account. For each sale an order is written up (usually by the salesman obtaining the order); a shipping order is prepared in the production planning department; a shipping notice is prepared in the shipping department; and, based on these forms and the order, an invoice is prepared in the billing department. Prenumbered forms are used. The invoices are recapped daily by products and recorded in the sales register. Posting to customers' accounts is from a copy of the invoice. A credit to the perpetual inventory is based on the shipping notice. Sales are all 2/10, n/30 from date of invoice. Credit memoranda for returns, etc., are supported by a receiving report, or are approved by the sales manager if they involve an adjustment or allowance.

Most collections are checks received by mail. The mail is opened by a clerk who prepares a list of the checks, which list is sent to the accounting department where it is later reconciled to the cashier's report for the day. The checks are turned over to a clerk who records them on a cash report after checking them as to the correctness of the discount, irregularities, etc. The checks are then turned over to the cashier who summarizes them and

enters them in the cash book, prepares the deposit ticket, and deposits them. The cash report goes to the accounts receivable bookkeeping section for use in posting to individual accounts. Checks or currency received from customers not remitting by mail are paid direct to the cashier, who issues a prenumbered receipt to the customer and sends one copy of the receipt to the clerk writing up the cash report.

Write-off of accounts as uncollectible is recommended by the credit manager and approved by the treasurer. There are about 3,500 accounts in the customers' ledger, which is divided into eight sections, each with a control summary.

Posting is by machine which accumulates the totals posted into each section of the ledger. These totals are posted to the section control. The average sale is $500 with a range of individual sales from $50 to $10,000. (AIA)

Problem 9–3. The A. B. Corporation lends money to its customers, taking their notes secured by warehouse receipts for merchandise in storage. All these notes, together with the warehouse receipts, are pledged by the corporation to secure bank loans. What steps should the auditor take to verify the notes receivable at the date of his balance sheet? (AIA)

Problem 9–4. As a part of the interim work in connection with an annual examination, undertaken two months before the end of the year, trial balances of the customers ledgers containing about 50,000 accounts were checked, footed, and agreed with the controls, and a satisfactory test circularization was made. All bookkeeping is done by hand. What additional auditing procedures, if any, should be followed in connection with receivables at the year end? The question of bad debts may be disregarded. (AIA)

Problem 9–5. (*a*) Discuss generally the auditor's procedure followed in connection with confirmations of account receivable balances. (*b*) Name the two principal types of confirmation requests and state the essential difference between them. (*c*) Give examples of other classes of assets or liabilities where each type is commonly used. (AIA)

Problem 9–6. Describe the procedure of examining for the first time the accounts receivable of a large merchandising concern. (AIA)

Problem 9–7. A manufacturing concern maintains a sales register and a separate register of returned sales and allowances to customers. Both are supported by a file of prenumbered duplicate invoices and credit memoranda, respectively. Outline an auditing procedure for the verification of the net sales for the year. (AIA)

Problem 9–8. The president of the Ajax Hardware Company, the customers of which are retail stores and building contractors, will not permit you, in your annual audit, to confirm customers' balances by correspondence. The company also does a substantial cash business with small contractors. The cashier is in charge of the company's bookkeeping and has one assistant who substitutes as cashier during the cashier's lunch hour. Charge customers are billed monthly and are allowed a discount of 2% if they pay their bills by the tenth of the month following purchase. A 5% discount is allowed on cash purchases.

Assume that you have reviewed the company's system of internal control over sales, and have determined that sales clerks prepare invoices or sales slips for all sales, and that these invoices are properly entered in appropriate sales registers. Footings in sales registers and cash book have been tested. (*a*) Outline the procedure you would follow in auditing the company's accounts receivable to satisfy yourself, in so far as possible, that the accounts receivable at the balance sheet date are authentic accounts and that there have been no irregularities in the transactions with customers. (*b*) Considering the conditions set forth, could you render an unqualified certificate? Discuss briefly. (AIA)

Problem 9–9. A large retail establishment writes off certain customers' accounts and notes by a charge to Reserve for Bad Debts but maintains a memorandum ledger for the accounts so charged off. State the audit procedure necessary in connection with the reserve account and the memorandum accounts. (AIA)

Problem 9–10. What additional auditing procedure should, or might, be undertaken in connection with the confirmation of accounts receivable where customers having substantial balances fail to reply after second request forms have been mailed directly to them? (AIA)

Problem 9–11. Describe a sales "cut-off" and indicate the auditing steps you would follow in making a sales "cut-off." (AIA)

Problem 9–12. You are engaged in an examination of detailed trade-accounts receivable for the purpose of appraising the adequacy of the relative reserve for uncollectible accounts. Indicate points that you would look for in the examination of individual accounts and the conclusions you would draw therefrom. (AIA)

Problem 9–13. You are verifying accounts receivable by direct confirmation. Submit columnar headings of a work sheet for the control of confirmation requests sent out and replies received. (AIA)

Problem 9–14. In studying individual balances shown in a trial balance of an accounts receivable ledger, it is necessary for the auditor to be alert with respect to certain factors which will influence his judgment as to the correct segregation and description of those balances for balance sheet purposes. Set forth these factors and the significance of each. (AIA)

Problem 9–15. Comparison between the interoffice account of City Wholesale Hardware Company and its suburban branch and the corresponding account carried on the latter's books shows the following discrepancies at the close of business, September 30, 1951.

1. A charge of $870 (office furniture) on HO taken up by branch as $780.
2. A credit by HO for $300 (merchandise allowance) taken up by the branch as $350.
3. HO charged branch $325 for interest on open account which branch failed to take up in full; instead, branch sent to HO an incorrect adjusting memo, reducing the charge by $75 and set up a liability for the net amount.
4. A charge for labor by HO, $433, was taken up twice by branch.
5. A charge of $785 was made by HO for freight on merchandise, but entered by branch as $78.50.
6. Branch incorrectly sent HO a debit note for $293, representing its proportion of bill for truck repairs; HO did not record it.
7. HO received $475 from sale of truck which it erroneously credited to branch; the branch did not charge HO therewith.
8. Branch accidentally received a copy of HO entry dated 10/10/51, correcting item 7, and entered a credit in favor of HO as of September 30, 1951.

The balance of the account with the branch on the head office books showed $131,690 receivable from the branch at September 30, 1951. The interoffice accounts were in balance at the beginning of the year. (*a*) What was the balance on the branch books before adjustment? (*b*) What is the correct amount of the interoffice balance? (*c*) Prepare a work sheet reconciling the amount of $131,690 on the HO books with the adjusted balance. (*d*) Prepare journal entry or entries to adjust the branch office books.

(AIA)

Problem 9–16. The owner of the Hanover Hardware Company, a large hardware store, suspects an employee of defalcation. He engages you to make a limited investigation, primarily for the purpose of discovering whether or not his suspicions are justified. You find the employee has charge of the accounts receivable detail over which no control is kept in the general ledger, also that he has access to the cash drawer in which proceeds of cash sales are kept. No one individual has exclusive charge of cash receipts, and no attempt is made to deposit the total receipts each day,

deposits being made from the cash drawer in even hundreds of dollars whenever deemed advisable by the manager. All checks received from customers, however, are to be deposited the day received. State two steps which you would take to aid you in forming your opinion. (AIA)

Problem 9–17. The following entries arouse suspicion of fraud. What do you think may have occurred? As independent auditor, what further steps would you take?

JULY CASH RECEIPTS BOOK

Date	Explanation	Cash	Cash Sales	Dis-count	Accts. Rec.
July 2	A. Customer	$ 1,300			$ 1,300
4	B. Customer	2,000			2,000
5	Cash sale (correct per register)	140	$140		
6	C. Customer	800			800
6	D. Customer	1,400			1,400
9	B. Customer	1,470		$ 30	1,500
10	A. Customer	784		16	800
15	D. Customer	2,646		54	2,700
19	C. Customer	1,176		24	1,200
20	Cash sale (correct per register)	170	170		
24	B. Customer	500			500
24	C. Customer	1,558		32	1,600
31	B. Customer	850			850
	A. Customer	500			500
		$15,294	$310	$166	$15,150

Summary Entry

Cash	$15,294	
Cash Sales		$ 310
Cash Discounts on Sales	166	
Accounts Receivable		15,150
	$15,460	$15,460

Customers' accounts appear below:

A. Customer Terms 2/10, n/30

	Balance	$1,300	7/ 2	Balance paid	$1,300
7/ 3	Sale	800	7/10	7/3 Invoice paid	800
7/ 4	Sale	1,200	7/31	7/4 Invoice on account	500
7/15	Sale	550			

B. Customer Terms 2/10, n/30

7/ 1	Balance	$2,000	7/ 4	Balance paid	$2,000
7/ 2	Sale	1,500	7/ 9	7/2 Invoice paid	1,500
7/ 9	Sale	500	7/24	7/9 Invoice paid	500
7/15	Sale	850	7/31	7/15 Invoice paid	850

C. Customer Terms 2/10, n/30

7/ 1	Balance	$ 800	7/ 6	Balance paid	$ 800
7/ 5	Sale	1,200	7/19	7/5 Invoice paid	1,200
7/16	Sale	1,600	7/24	7/16 Invoice paid	1,600
7/24	Sale	700			

D. Customer Terms 2/10, n/30

7/ 1	Balance	$1,400	7/ 6	Balance paid	$1,400
7/ 4	Sale	1,500	7/15	7/4 and 7/10 Invoices paid	2,700
7/10	Sale	1,200			
7/20	Sale	900			

(AIA)

Problem 9–18. You are assigned to verify the notes receivable of the Orgill Company at December 31, 1951, and find the following information in the accounts. (*a*) Prepare a work sheet showing beginning and ending balances for notes receivable and accrued interest together with all transactions during the year. (*b*) Indicate on the work sheet the verification necessary to support all balances and transactions. (*c*) Prepare any adjusting entries you consider necessary.

Notes Receivable

1/ 1	Balance fwd.	$1,980.00	1/13	#18, S. O. Late	$700.00
1/15	#22, H. W. Soon, 30 days, 4%	300.00	2/14	#22, H. W. Soon	300.00
3/15	#23, V. Y. Fast, 60 days, 5%	650.00	2/18	#20, O. N. Time	500.00
6/10	#24, G. O. Slow, 90 days, 5%	550.00	4/ 4	#21, T. O. Early	780.00
9/16	#25, O. V. Due, 120 days, 5%	800.00	5/14	#23, V. Y. Fast	650.00
11/30	#26, D. E. Falt, 90 days, 5%	750.00	9/ 8	#24, G. O. Slow	550.00

Interest Received

	1/13	7.00
	2/14	1.00
	2/18	6.25
	4/ 4	13.00
	5/14	5.42
	9/ 8	6.38

Accrued Interest Receivable

1/ 1	Balance fwd.	11.65	

You are able to discover from your own work papers for the preceding year that the balance of notes receivable at January 1 consisted of three notes, as follows:

#18, S. O. Late, 90 days, dated 10/15, 4%	$ 700.00
#20, O. N. Time, 90 days, dated 11/20, 5%	500.00
#21, T. O. Early, 120 days, dated 12/5, 5%	780.00
	$1,980.00

Problem 9–19. The following paragraphs represent exceptions found on accounts receivable confirmation requests returned directly to you by customers of the Moffitt Company whose records you are examining. For each, state the specific records or documents you would refer to in investigating the exception and also explain your purpose in referring to the record or document.

1. Confirmation #14, Broadbent and Son, $780. "Credit requested December 28."
2. Confirmation #26, G. Hanson, Inc., $1,410. "Paid this December 31, our check #2537."
3. Confirmation #42, Henderson and Henderson, $960. "No such account per our records!"
4. Confirmation #46, Kelly Service Co., $465. "Your merchandise was in such bad condition we would not accept delivery from express company. Please reship immediately."
5. Confirmation #63, Landgren Transportation Company, $817. "Please supply our purchase order numbers to facilitate checking."

Chapter 10

VERIFICATION OF INVENTORIES

Inventory is another of the most important and most difficult verification problems with which an auditor is faced. It is commonly the single greatest current asset and is often the largest asset in the entire balance sheet. Any error in inventory affects net income directly, and an inventory error of 10 or 20 per cent may be big enough to erase or double the net income for the year. A redeeming and somewhat relieving feature, however, is that as far as the overall net income results are concerned an error (intentional or otherwise) made at the end of a period in deriving the amount of inventory adjusts itself when the next succeeding inventory is entered, whether it is a month or a year later. Such self-adjustment is effected because the closing inventory of the first period becomes the opening inventory of the second. Since the inventory is also an important item in the balance sheet, however, where such self-adjustment is not possible, the importance of following a good audit procedure is obvious.

The difficulty of verification lies to some extent in the variety of possible errors which affect the inventory but more particularly in the nature of inventory itself and the transactions which affect it. To be certain that an inventory total is completely reliable, one must verify the following:

1. Physical existence and ownership of the inventory.
2. The quantities included in making inventory extensions.
3. The prices used in making inventory extensions.
4. The arithmetical accuracy of extensions, footings, forwardings, and final totals.

The most difficult problem is that of pricing the inventory, because price is essentially a matter of quality and grade. Few auditors can be experts in materials as well as in the intricacies of accounting and verification. Most auditors are called on to examine a wide variety of inventories during the course of a year, and it becomes humanly impossible for them to be expert enough in all lines to determine whether grades and quality are as claimed. A given auditor may in the course of a

single year be called on to examine the accounts and therefore the inventories of a lumber company, a wholesale drug company, a jewelry manufacturer or retailer, a steel fabricating plant, a grain elevator, and any number of others. It becomes apparent that the problem of determining the appropriate price to be used for such a variety of inventory items, considering the possible variation in grades within each class, is more than he can solve to his complete satisfaction.

A lesser problem, but still one of real difficulty, is that of arriving at correct inventory quantities in view of the fact that the inventory is continually changing because of receipts and shipments. Some concerns close down their plant and cease operations to take inventory. Others provide only a partial shutdown or sometimes take their inventory during a slack season with no cessation of operations at all. This makes for considerable difficulty in obtaining a count as of a specific time that can be tied in closely with the records of purchases and sales.

Because of the materiality of the inventory in most cases and the difficulty of some of the problems involved in its verification, extreme care must be exercised in all phases of the verification.

Basic Verification Techniques in Inventory Examination. The relationship of audit procedures to basic verification techniques is pointed out at opportune times throughout this book. In those preceding chapters that dealt with the verification of specific items the procedures were given first and their nature as applications of the basic techniques was indicated at the end of the chapter. As a student progresses to the point where he can begin to prepare audit programs himself, he must think of the techniques first and think of them as leading into specific procedures. To aid in the development of this ability to plan audit programs, in this chapter the pertinent techniques are noted first and their application through procedures follows.

As might be expected in an audit problem as difficult and as variable as that of inventory examination, all the basic techniques have some usefulness and are applied in one way or another under various conditions. Thus the problem of planning a verification program for inventories is not so much one of selecting the applicable techniques as it is one of determining which are most useful and therefore should be emphasized the most, and then of integrating them so that each supports the other.

To ascertain existence of the inventory claimed and to prove the quantities it seems that physical examination and count will be required, and at first thought they might seem adequate for the purpose. Yet

unless some means is found to relate the auditor's physical examination to the total inventory amount claimed by the company under examination, much of the value of his physical examination may be lost. It is not enough merely to have seen and counted some materials which the company claims as inventory. The quantities examined and counted by the auditor must be traced directly into the inventory listings on which the company's inventory total is based.

In addition, it is possible that errors might have been made in the many arithmetical calculations necessary to accumulate the final inventory amount. This calls for the use of recomputation to test footings, extensions, and totals. Also, any errors in the prices used by the company for pricing the inventory items will result in errors in the final figure and errors which easily might be substantial. Therefore, examination of such documents as invoices to ascertain the reasonableness of the prices used by the company for inventory purposes is also called for.

Another problem is found in the fact already pointed out that the inventory is counted as of a given date, and it is likely that shipments to and from the storeroom will be taking place close to the inventory date and perhaps even while the inventory is being counted. Out of this possibility comes the need for a careful examination of the documents which indicate the quantities that have been received or shipped close to the inventory date.

In individual situations it is possible that additional applications of the basic techniques may be called for. For example, inventory stored in a public warehouse, if the quantity is not material, may be verified by confirmation. Others are explained in this chapter. The student should make an effort to relate each audit procedure to the basic technique it represents and at the same time make sure that he understands its purpose in the overall verification program if he is to attain the background essential to the development of audit programs. Without the ability to develop satisfactory audit programs for new and unusual situations success in auditing is impossible.

Essentials of Verification of Inventory. The important inventory verification procedures can be related directly to the various possibilities of error just as the procedures for cash were related to the purposes of cash verification.

1. Physical existence and quantities.
   A. Be present when physical inventory is taken.
      (*a*) Observe existence of inventory.

(*b*) Observe inventory-taking procedure including the efficiency with which the members of the inventory crews perform their tasks.
(*c*) Make test counts of inventory quantities.

B. Trace test counts into company's inventory listing.
C. Trace company's inventory counts as indicated on inventory tags or other record of original counts into company's inventory listing.
D. Account for all inventory tags or tickets.
E. Review purchase and sales cut-off, and make tests to insure accuracy of inventory count with respect to shipments close to the balance sheet data.

2. Pricing.
   A. Make test of specific prices used by company comparing them with recent invoice or quoted prices.
   B. Review method of pricing with the intention of determining if a generally accepted pricing policy has been followed.
      (*a*) Determine general pricing practice.
      (*b*) Review composition and application of burden rate.
      (*c*) Investigate balances of any standard cost variation accounts and the disposition thereof.
   C. Apply gross profits test or its equivalent.
   D. Determine that quality and grade are reasonable.
      (*a*) During observation of physical inventory, determine whether inventory is in a merchantable condition.
      (*b*) Review detail inventory records for slow-moving and obsolete items.
      (*c*) Refer to purchase invoices for major inventory items to determine whether that grade or quality is handled in the quantities indicated.
3. Clerical accuracy.
   A. Test by recomputation inventory extensions and footings.
   B. Trace all forwardings into summaries and into the final inventory amount.
4. Accuracy of inventory amount in general.
   A. Obtain an inventory representation from company officers or employees.

Observation of Physical Inventory. No matter how efficient a system of detailed inventory records a company may have, periodic physical inventory counts are necessary to make certain that the records are in agreement with the quantities actually on hand. Most concerns take a

complete inventory at least once a year, generally at or near the end of their business year. This provides an auditor with an opportunity to accomplish necessary verification, an opportunity not to be missed.

The presence of the auditor during physical inventory taking is required for three distinct reasons:

1. So that he can see the inventory and assure himself that the company does possess the goods claimed.
2. To observe the methods followed by the company in arriving at their inventory figure in order that he can evaluate the adequacy of the inventory procedure in obtaining an inventory total.
3. To make counts of some of the inventory quantities so that those counts may be traced into the company's inventory lists at a later date.

Verification of the existence of inventory items seems so simple and fundamental as to scarcely warrant mention. Yet important instances of fraud have been overlooked in the past because no effort was made by the auditor to assure that the goods actually existed and were owned by the company under examination. Without a sure knowledge of the existence of the goods which the records purport to represent, testing of prices and clerical accuracy is of little value.

In satisfying himself as to the existence of inventory, an auditor should remember that all major components of the inventory should be included. If, for example, a company has inventory stored at its main plant, more at a nearby warehouse, and another part a considerable distance away at a branch warehouse, the auditor or his representatives should assure themselves that inventory is actually stored at each of those locations. Likewise, if an inventory includes raw materials, finished goods, and work in process, he must see some of each class and see quantities at least roughly equivalent to those claimed by the company. Again, if the inventory includes several different lines of merchandise, each line of material importance should be seen in the verification of physical existence. It is not necessary to visit every possible location or every type of merchandise handled because the theory of testing is applied here as elsewhere in verification. The test, however, should certainly take into account the number and importance of warehouses, lines of merchandise, and the like.

Observation of the procedures followed by the company employees in taking the inventory implies familiarity on the part of the auditor with the company's instructions to the inventory crews. Most concerns will have some kind of written instructions to the inventory party; these will

assign each one his task and state how counts are to be made, inventory tags spotted and picked up, and areas of the plant released for regular operations after the inventory taking has been completed. An auditor who is charged with the duty of reviewing the inventory procedures should first obtain a copy of the inventory instructions and study them carefully. Frequently he can make suggestions for their improvement which may facilitate the entire inventory procedure. On inventory day he should be present in the inventory area to ascertain whether the various crews are following their instructions in an effective and conscientious manner. He is not a detective or an informer, yet he is definitely interested in an accurate inventory. Hence, if he finds crews which for one reason or another are not following instructions or are apparently not doing a thorough job, he should find occasion to report such dereliction of duties to their superiors. Frequently the mere presence of an auditor is sufficient to encourage reluctant employees to do a better job.

As with physical existence, an auditor should attempt to obtain as wide coverage as possible. He should not be content to observe the activities of only a few crews or employees, but should move from department to department observing as many employees and as many different operations as possible. He must ascertain not only the accuracy with which count crews are working but also such related matters as the condition of the stock for counting, the segregation of obsolete or shopworn items, and the amount of operating activity with its attendant effect upon the overall accuracy of the inventory count.

On completion of his observation, his conclusions as to the effectiveness of the inventory procedure should be written up and included in the work papers as an item of evidence indicative of the accuracy of the inventory total.

In addition to satisfying himself as to the existence of the inventory and the efficiency with which it is counted, the auditor must also make a number of test counts of inventory quantities. Counts made by the auditor are additional evidence that the company count crews are counting accurately (or inaccurately as the case may be). They also provide a direct tie-in from the actual goods in the storeroom or shop to the inventory list, give a basis for determining the accuracy with which counts are transcribed onto the inventory lists before pricing, and are some evidence that quantities on hand are not omitted from the inventory listings.

It should be remembered that an auditor is not supposed to take inventory. Neither is his job to supervise the inventory taking. He is there to determine the accuracy with which the company arrives at its

inventory total. In some cases he is asked to take or to supervise the inventory and may accept the assignment. He then ceases to be an auditor in respect to that particular phase of the accounting work. The essence of an audit is independent review by a qualified person. One cannot audit his own work because he cannot be independent of himself. Hence, if an auditor takes the inventory he cannot be said to audit it.

In making test counts it should be remembered that there is no necessity to count the entire inventory. Selected items should be counted, not all items. An alert person can usually tell which are the important inventory items and will concentrate his counting on such goods. There should be no advance indication of which parts of the stock he intends to count so that the items actually selected are a surprise to the inventory crew; this has a real advantage in encouraging them to count all quantities as accurately as possible.

Perhaps the easiest procedure in making test counts is to follow a count crew and count quantities which they have already counted and tagged. This gives the auditor the advantages of being able to take off their description on his work papers and to check his count against theirs. If he locates an apparent error he can make a recount, and if then convinced that an error has been made by the count crew can request that they count it again and clear up the mistake immediately.

A simple work sheet should be prepared in advance for the recording of test counts. In entering his counts on the work sheet, the auditor should remember that it is entirely possible that not he but someone else will be assigned the task of tracing those counts into the inventory lists. This means that the work sheet must be legible, and that descriptions must be uniform with those used by the company.

The problem of counting large quantities stacked in solid piles is always a difficult one. There is often a question whether the stack is really solid or whether it contains a "hollow square." In addition there is a possibility that empty containers may be included to appear as full ones. The best precaution against practices of this type is to discuss in advance of the inventory date the problem of preparing the stock for counting. Provision can then be made for leaving aisles within the larger stacks which effectively preclude the use of a material hollow square. Occasional movement of or contact with a container while counting should be sufficient to assure oneself that no empty boxes are included. Only if there are real grounds for suspicion should one request that a pile be restacked or moved.

The quantity of grain in an elevator or of liquids stored in tanks may have to be computed on the basis of measurements of the depth of the

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Tag no.	Description	Location	Count per Tag	Count per Audit
86	Copper fittings CF-28	Stores #2	417	417 n
87	Copper fittings CF-39	"	318	318 n
112	Brass valves 419	"	434	434 n
115	no 47 collars	"	188	188 n
431	Connectors #261	"	1440	1440 n
432	Connectors #263	"	689	689 n
218	Tube and needle sets #14	Assembly	814	814 n
220	Cut-off valves #3c	"	324	324 n
227	Fitted vents, size A	Stores #4	90	90 n
228	Fitted vents, size C	"	68	68 n
315	Angle rockers	"	112	112 n
320	Electric motors - #218	Stores #3	43	43 n
326	Electric motors #221	"	54	54 n
324	Switch box assemblies	"	814	814 n
325	Switch boxes, not fitted	"	400	400 n
336	Control panels - A 19	"	34	34 n

Our count agrees with company in all cases. Differences in count for tags #218 and 324 corrected by recount by company's inventory crew.

n Traced to company's inventory lists - RKM 3/2/55

Illustration 15. Work sheet for inventory test counts.

contents contained and of the container. Where coal or the like is piled in a yard, reference may be had to engineers' estimates as the best means of verifying the quantity claimed. Where material amounts are concerned, the quantities claimed can be checked against book records of quantities received and issued.

There frequently appears a tendency to emphasize the test count part of inventory work at the expense of the observation of inventory pro-

cedures as applied by the company employees. All three purposes of being present at physical inventory taking must be accomplished, and an auditor has the responsibility of obtaining a reasonable balance of the work required to accomplish each.

Tracing Counts into Inventory Listings. As indicated in the program presented earlier in this chapter, both the test counts made by the auditor and at least a sample of the inventory tags or other record of counts made by the inventory crews should be traced into the inventory listing. An auditor is rarely able to make enough counts himself to provide a real basis for testing the accuracy with which the inventory lists have been compiled from the count tags. Hence the test is expanded by using some counts made by the company.

In tracing the entry from the tag into the listing, one should review carefully not only the quantity recorded in the list but also the description. An incorrect description may result in incorrect pricing, and could thus give rise to as significant an error as if the wrong quantity had been used. One of the real problems in listing inventory counts is to make sure that the item counted received the correct description in the listing. Shop and storeroom workers frequently have what might be called slang terminology for parts which are given an entirely different name in the catalog or official parts list. For example, something described on the count tag as a "three way tie" might be described officially as a "connector L 17." When the count tag is listed, the person doing the listing is faced with interpreting the slang description to the best of his abilities. Any cases of this nature in which material quantities are involved should be carefully investigated by the auditor to make sure that the correct description of the items counted has been used in the listing.

It should be apparent that the work of tracing counts into the listing must be done some time after the counts have been made. On the inventory date the auditor is present to observe and make his test counts. He can then do little more on inventory verification until the company has sorted and listed its count tags, inserted inventory prices, extended the quantities times the prices, and totaled the inventory sheets. Thus as much as several weeks may elapse before counts are traced into the inventory lists. This is another reason for making all count sheets clear and self-explanatory.

Account for All Inventory Tags. One part of the internal control over inventory taking should provide for the numbering of all inventory tags. Some type of control should be worked out by the individual in

charge of the inventory taking so that tags are issued in such a way that the numbers of those issued are known and so that all tags issued are checked back in, whether used or not. It should be apparent that, if no control over inventory tags is maintained, counts may be lost or perhaps the same material counted more than once. Whether tags issued are used or not, or even if spoiled, they should be retained and turned back in to the person in charge so that it is certain that none has been lost or misplaced. An auditor should review in advance the procedure established by the company to insure that no count records are lost, and then during the inventory procedure should observe whether the procedure is being followed satisfactorily.

Of course, there is always possibility of lost tags after the count has been completed and before the count tags or cards have been turned in to the office staff for listing and pricing. It is therefore a requirement that some attention be given to determining whether all tags have been included in the listing. To some extent this is covered by tracing a sample of the tags into the inventory list, as described in the preceding section. It is also well to make at least a test of the cards on file to determine whether all numbers used are present. If the company files its count tags in numerical order, a test of this nature is easy to make. If some other method of filing is used, it may be necessary to request that a portion or all of the tags be re-sorted numerically to permit the test.

Purchase and Sales Cut-Off. One of the difficult points in regard to the verification of inventory quantities has to do with determining whether all merchandise on hand and the property of the company has been included in the inventory and in purchases, and that merchandise not the property of the company has not been included in the inventory or in purchases. If all goods on hand are counted in the physical inventory, some stock may be counted for which the company has not yet received an invoice or charged the Purchases account. Other merchandise for which the invoice has been received and entered may not have been delivered yet, and so cannot be counted with the merchandise on hand. The same type of problem is met with in regard to sales, for goods already sold and recorded as such may still be on hand and therefore be included in the inventory count; goods already shipped to customers but on which title does not pass until it reaches its destination may be omitted from the inventory although not recorded as a sale.

The relating of the inventory and the purchases and sales records is known as obtaining a cut-off of purchase and sales transactions. To

find out whether an accurate cut-off has been obtained and to determine the extent of any error that may have been made is part of the inventory verification task of the auditor.

Particularly close attention must be given to purchase and sales transactions close to the end of the period. The time at which title to the goods passes from one party to the other, the time of entry in the company records, and the inclusion or exclusion of the material from the physical inventory count must all be considered. Two separate steps are generally necessary on the part of the auditor in proving the accuracy of the cut-off. First, special attention must be given to counting the merchandise in the shipping room and in the receiving room at the time the inventory is taken. This is important in order that recent shipments or receipts of goods may be discovered so that there will be no question whether they were or were not included in the total inventory as counted.

The second step requires that the sales and purchase transactions close to the inventory date be segregated for study as to their entry in the records and as to whether that entry or omission of entry agrees with the inventory counts and the situation as to title.

For purchases, the purchase transactions for perhaps the last five days before the inventory date and the first five days after the inventory date should be listed. Reference should then be made to the purchase invoices involved to determine the terms of shipment, date of shipment, etc. Receiving reports should be examined to determine when the goods arrived, as that may be an important feature in determining when title passed and is also important in indicating whether the goods were counted in the physical inventory. For any doubtful shipments, further tracing into the physical inventory counts or the inventory listing is required.

This procedure should result in a work sheet with the following type of information:

Date Entered	Terms	Date Received	Date of Invoice	Company's Property	Included in Inventory	Amt. of Invoice
12/29/51	F.O.B. dest.	12/28/51	12/26	Yes	Yes	$4,000
12/30/51	F.O.B. dest.	1/ 2/52	12/27	No	No	3,500
1/ 2/52	F.O.B. sh. pt.	12/31/51	12/27	Yes	Yes	4,300
1/ 4/52	F.O.B. sh. pt.	1/ 2/52	12/28	Yes	No	2,800

For the items illustrated it should be noted that the first one requires no adjustment. The goods were the property of the company on the inventory date because the terms of shipment were F.O.B. destination

and the goods had been received. The invoice had been entered in the purchases book, and the physical inventory count included the merchandise represented by the invoice.

The second case is somewhat different. Here the terms of sale were F.O.B. destination, but the goods were not received until after the inventory date; hence they were not the property of the company. They were not included in the physical inventory, which is correct, but had been entered in the purchases book before the inventory date. This entry is in error and requires adjustment by the auditor.

In the third instance, title to the goods had passed and the merchandise was the property of the company on the inventory date. No entry had been made for the merchandise until after December 31, so an adjusting entry is required to record the purchase within the year 1951. The goods had been included in the inventory count, so no adjustment of the inventory total is required.

The last case requires adjustment of both the inventory total and the record of purchases. Title to the goods had passed before the inventory date, although the merchandise had not been received nor entered. As it had not been received, it was omitted from inventory.

In adjusting the inventory figure in such situations, two possibilities are found. The inventory amount may have been entered already by the company, in which case journal entry adjustment is required by the auditor either to increase or decrease the inventory and the other account or accounts concerned. In other instances the inventory total will have been computed but no entry made until after the auditor has completed his verification. Here journal entry adjustment is not required; all that is necessary is to change the inventory total before it is recorded by closing entry.

The problem of testing the sales cut-off is similar to that of proving the purchases cut-off. Sales on both sides of the inventory date must be investigated as to date of entry, time of passage of title, and inclusion in the inventory total. To determine actual date of shipment, it may be necessary to refer to shipping documents rather than to rely on the sales invoice date.

The preceding comments on cut-off and other precautions seem to apply largely to merchandising rather than manufacturing. It should be observed, however, that in a manufacturing plant, similarly, raw material might be included both in the storeroom inventory and in work in process if a cut-off is not made with care. In like manner, care should be exercised in effecting a cut-off between work in process and finished goods in order to avoid duplication of items.

Test of Specific Prices. Generally accepted accounting permits the use of either cost or the lower of cost or market for inventory pricing purposes. In either case an auditor must determine that the basis which the company purports to use is actually being used and is being applied correctly. The test of specific prices for inventory items is aimed at discovering whether or not the company is applying its pricing method correctly.

A selection of inventory items to be tested must first be made. Generally, the more important inventory items are chosen as they give the test greater coverage, but some attention should also be given to smaller items as a cumulative error in a series of small items may become serious. Items to be tested are taken from the company's completed inventory sheets together with the quantity, price, and extension. The auditor then refers to recent purchase invoices, to quoted market prices, to catalogs, or, if necessary, writes directly to the supplier to ascertain what the current market price was at the inventory date. This price is inserted on the work sheet, and if it differs from the one used by the company a new extension is completed and the difference between the company's extension and that of the auditor indicates the amount of adjustment required.

If the company prices its inventory at cost, reference should be made only to purchase invoices, as they will indicate what cost actually is in each case. If the lower of cost or market is to be applied, then any price quotation current at the audit date and applicable to the quantities included in the company's inventory may be used.

The American Institute of Accountants has recently stated that the generally accepted method of applying the lower of cost or market valuation procedure to inventories does not necessarily require its application to individual items but only to the inventory in total or to major sections of the inventory. This does not eliminate the necessity for a test of specific prices as only by such a test can the importance of the difference between cost and replacement cost be determined. If anything, it implies that the test should be broadened to include a sample from all major portions of the inventory so that any difference between cost and the lower of cost or market disclosed by the test may be used as a guide in adjusting the total inventory valuation.

Method of Pricing. Inherent in the test of specific prices described in the preceding section is some review of the pricing method in use and a decision as to its adequacy in the circumstances. If the company is a manufacturing concern, however, further tests are necessary to determine

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Item	Supplier
Copper fittings CF 28	Copperweilders, Inc
Three inch valve # 817	Strong Bros
Electric motors # 117	Enright Motor Co
Condenser fittings # A 13	Milwaukee Brass Co
Grid assemblies X 13	Central Parts Supply
Grid covers - 4' size	Milwaukee Brass Co
Rubber tube sets	Reo Rubber Materials Co
Side-arm braces 150	Brunco
Suction sets LT4	Electric Supply Co
Assembled condenser Y14	Enright Motor Co
L-12 Transformers	Enright Motor Co
L-12 Transformer controls	Handy & Son
Standard wall type braces	South Side Metal Works
Extra length rocker arms	Strong Bros
Fan assemblies	Westinghouse

Illustration 16. Inventory

that generally accepted methods are followed in the pricing of finished goods and work in process. The auditor must investigate by such means as are available the costs which the company includes in its inventory of finished goods. If administrative or distribution costs are included incorrectly, they must be eliminated from inventory by adjusting entry. On the other hand, inventory cost should include all costs of manu-

Rsm
2-7-55

	Per Company		Per Audit		Over / Under Market
Quanity	Price	Extension	Price	Extension	
214	350	74900	350n	74900	
114	2000	228000	2050n	233700	5700
47	2450	115150	2450n	115150	
318	210	66780	210n	66780	
2420	900	2178000	900n	2178000	
816	160	130560	150n	122400	8160
2958	210	621180	200x	591600	29580
1112	80	88960	80n	88960	
310	2100	651000	2100n	651000	
1750	230	402500	250x	437500	3500
814	1400	1139600	1400n	1139600	
780	500	390000	500n	390000	
1850	150	277500	150n	277500	
712	125	89000	125n	89000	
914	600	548400	650n	594100	4570
		7001530		7050190	48660

n Price per recent supplier's invoice for approximately same quanity

x Price per supplier's price list, no recent invoice available

price test.

facture and should not omit items of burden merely for purposes of conservatism.

Discussions with company employees and officials may yield the desired information, but in general it is more satisfactory to work directly with cost records. Job cost sheets, specification lists, analyses showing composition of burden rates as established by the company, and similar

records should be called for and scrutinized carefully with the view of determining if the company's cost accumulation is in accord with sound accounting.

Burden is a particularly difficult problem in cost accounting and one with which the auditor must be concerned. Any error in the burden rate affects both the inventory amount and the profit for the period, and if the error is material should be discovered and corrected. In most cases the auditor can do little more than apply a rough test to determine whether the rate applied is reasonable, but he should at least do that. He has the advantage of working with the cost data after all indirect costs for the year have been determined; the total labor hours or other basis used for apportioning burden to product will also be known. Hence in a brief computation he can work out what the rate should have been, and thus discover whether or not any material error has been made.

Any variation accounts resulting from the use of standard costs likewise should be analyzed, if the company has not already done so, and their disposition scrutinized. Excessively large balances at least suggest that the standards may be in error and require adjustment.

Gross Profits Test. The gross profits test is no more than a rough approximation of what the inventory should be, yet it is an invaluable aid to an auditor. The test of specific prices used in the inventory is aimed at individual prices and is not of much assistance in discovering over- or understatement of the inventory total. Calculation of the inventory amount by the gross profits test does give some clue as to whether the inventory total is or is not out of line, and gives that information with the minimum of time and effort. It is, of course, much more useful and accurate if it can be applied on a departmental or some other basis that takes into account different rates of gross profit within the concern.

Another test which may be used to supplement the gross profits test and which, like the gross profits test, gives an indication of the validity of the inventory total, relates the inventory to the sales of the following month or two months. If this is done on a comparative basis over a period of years it becomes very helpful in pointing out either overstatement of inventory or the accumulation of unsalable stock. It may be set up as follows:

	1954	1953	1952
Inventory, December 31	$190,000	$165,000	$140,000
January sales	50,000	48,000	45,000
February sales	48,000	50,000	47,000
Total January and February sales	$ 98,000	$ 98,000	$ 92,000

The concern in this illustration has a greatly increased inventory over the preceding years but is doing little more than maintaining the same sales volume. Any one of several factors might account for this, but it is a matter which the auditor should investigate because of the implication that the inventory may be overstated. His investigation might consist of little more than inquiry of company officials and employees but surely should include a careful application of the test described in a later section as a review of the detailed inventory records.

Quality and Grade of Inventory Items. As discussed in the opening paragraphs of this chapter, it is seldom possible for an auditor to be an expert on the subject of quality and grade of the inventory items he is called on to verify. In counting lumber in a lumber yard, he may have a difficult time distinguishing one type of wood from another without getting into the complexities of grades within the various types. In such instances he is forced to use the descriptions given by the company employees.

That does not mean that he must accept them without question. An auditor has very definite responsibilities in regard to grade and quality which he can discharge without either being an expert himself or calling on an independent expert for assistance. An auditor should at least determine that the inventory is in merchantable condition and that no items are included in the inventory in any material quantities which are not dealt in regularly by the concern.

During his observation of the physical inventory taking he has an opportunity to view a considerable portion of the company's storeroom and shop space. He should be constantly alert to the possibility of obsolete, shopworn, or damaged merchandise, and should not hesitate to inquire as to the condition of goods which do not appear to be carefully stored or protected. Searching inquiry should be made of company officials as to their procedure in disposing of obsolete parts or products.

In addition, a review should be made of the detail inventory records for obsolete and slow-moving items. A considerable amount of information is contained within the detail or perpetual inventory records, and an auditor should not omit using such records. Almost every company has such records to aid in its control of inventory. For each item in the inventory there should be a page or card showing increases, decreases, and the balance on hand together with the date of every transaction. Merely by scanning each inventory card it is possible to determine whether or not the particular item is currently used or not. If there have been no issues of a given part for six months or more, some ex-

planation should be requested. A careful perusal of the inventory cards often brings to light more information about slow-moving stock than can be discovered in any other way.

Many controllers "age" their inventory periodically on the basis of the detail inventory records in order to discover which items are not in current use. If this has been done recently, the auditor can test the company's work sheet and use it in determining the necessity for any adjustment. If no such procedure is applied by the company, it becomes the duty of the auditor either to perform that task himself or to see that the company does it under his direction. At least a test of the major inventory items is a necessity if he is to assure himself that obsolete items are not included in the inventory at full value.

To assure himself that the inventory descriptions as to grade of the various items are correct, an auditor should refer to purchase or sales invoices of the major inventory items. This may already have been done in connection with the test of specific prices, but if it has not been done it should be at this time. If a canning company describes and prices several thousand cases of tomatoes as Grade A in its inventory but its sales records show no or very few sales of Grade A tomatoes, the auditor should be suspicious and inquire further of the management. If a company claims the highest-grade raw materials in its inventory but has no purchase invoices of that quantity and quality in its files, there is some question whether the inventory is properly described. Thus, by reference to the transactions into which the company has really entered, a very useful test of grade and quality can be made.

By alert observation of the condition of the goods during the physical inventory-taking process, by scanning the detailed inventory records, and by referring to purchase and sales documents for major inventory items, an auditor can make a very effective test of inventory quality and grade without in any way being an expert in materials.

Clerical Accuracy. In tracing inventory tags into the inventory listing, the accuracy with which that phase of the inventory work was performed has been tested. The accuracy of extensions, page totals, forwardings into summaries, and the footing of the summaries must also be tested.

In testing inventory extensions and footings it is seldom necessary to check the exactness of the amount. Frequently extensions can be sight tested. That is, the auditor scans the quantity, the price, and the total, and by means of a rough mental calculation determines whether it is or is not reasonably accurate. This is satisfactory because he is not search-

Rogers, Clarke & Company, C.P.A.'s
Bankers Building
Chicago, Illinois

Gentlemen:

In connection with your examination of the financial statements and accounts of the Jones Mercantile Company as of the close of business December 31, 1954, the undersigned makes the following statements:

I am fully familiar with the quality of the merchandise inventory and its salability at that date and with the methods employed in the inventory taking. Quantities were determined by actual count, weight, or measure. There was not included in the inventory any merchandise consigned to the company which had not been paid for or acknowledged as a liability on the books of the company. None of the stock included in the inventory had been hypothecated, and no merchandise sold and billed at that date was included.

The inventory has been priced on the basis of the lower of cost or market, appropriate allowance being made for slow-moving or obsolete merchandise. These valuations are in all cases sufficient to allow a reasonable margin of gross profit considering current selling prices and current costs of doing business.

In my opinion the inventory amount of $285,948 is a true and correct valuation of the merchandise inventory of this company on December 31, 1954, and you are fully justified in including this amount in your report.

Very truly yours

Illustration 17. Inventory representation letter.

ing for errors in the cents or dollars columns, but is interested in major errors such as result from misplacing a decimal point, including or omitting a zero, or raising an extension by a large amount. In the same way, a test of footings of page totals may omit the cents and dollars columns and begin only with the tens, or sometimes even the hundreds, column. Sight testing and footing as described will serve to locate any significant inventory errors and greatly expedite the lengthy task of testing involved.

Inventory Representation Letters. During the course of his examination of the inventory, an auditor will find it necessary to ask a great many questions as to the pricing methods in use, the uniform application of inventory-taking procedures, the existence of any consigned merchandise, any pledging of inventory as security for loans, and the like. To have evidence in his work papers that such questions have been answered by the company officials, it is common practice to obtain from them what is frequently known as a letter of representation. A statement by the company employees or officials, whoever is best informed on the subject, as to the facts regarding inventory taking, pricing, and condition is made in the form of a letter to the auditors and signed by the company people concerned. To insure that the letter includes the information desired by the auditor it is customary for him to draft the letter and then to submit it to the company officials for signature.

It should be made clear that an inventory representation is in no way a substitute for any other verification procedures. It is definitely not a guarantee by company officials or a shifting of responsibility for verification from the auditor to them. It is merely a formalization of the answers that an auditor would normally request during the application of other verification procedures.

PROBLEMS—CHAPTER 10

Problem 10–1. You are to verify the finished goods inventory of a manufacturer in connection with an annual audit.

Present, in outline form, a complete audit program such as would ordinarily be followed in the verification. (AIA)

Problem 10–2. A manufacturing concern keeps a perpetual book inventory of raw materials and supplies. All accounts of the stock ledger are continuously checked with the quantities actually on hand. This takes place at least once in six months and also when stocks are low and have to be replenished. The date of each count is noted on the stock ledger accounts, and adjustments are made after proper investigation of differences discovered. No physical inventory is taken at the close of the fiscal year. How will you verify this inventory? (AIA)

Problem 10–3. (*a*) State in a general way to what extent physical tests of quantities should be made in the verification of inventories. (*b*) Describe the extent of reasonable physical tests in the verification of the following specific types of inventories:

1. Scrap and ore at smelting furnaces.
2. Merchandise held for sale by a wholesale jobber of dry goods.
3. Operating, maintenance, and repair supplies in a factory.
4. Merchandise held for sale by a retailer of men's or women's clothing.
5. Merchandise held for sale by a dealer in musical instruments, pianos, radios, phonographs, etc. (AIA)

Problem 10–4. How should an inventory be checked under circumstances as follows:

The client operates several retail stores selling numerous household utensils at retail and also has a warehouse all in one city.

A perpetual inventory is kept at the general office showing quantity, unit price, and location of the goods and is supposed to be under good accounting control.

Employees of the client, working in teams of two men each, take the warehouse inventory on numbered sheets.

The inventory in the stores is taken on serially numbered tags. One employee enters the description on a tag in two places and fastens it to the article. A second employee verifies the description, tears off one half of the tag, leaving the other half attached.

Inventory sheets and torn-off portions of the tags are turned in to the head office and unit prices are entered, previously revised to the lower of cost or market, or reduced for slow-moving, less-salable, and damaged goods.

An outside service company is hired to make extensions and additions and to make a fair copy and summary of the inventory.

The auditor received instructions several weeks before the date of stock-taking. (AIA)

Problem 10–5. A client operated a chain of twelve retail drug stores. A central office and warehouse was also maintained where all accounting was performed. The perpetual inventory records, maintained at the central office, are kept in terms of unit quantity, total quantity, unit cost price, total cost price, unit sales price, total sales price, and warehouse or retail store location. The inventories, both warehouse and store, were taken by company employees under the supervision of the independent auditors, who had prepared the inventory-taking instructions.

The inventories were taken on serially numbered, duplicate perforated tags. The inventory crews worked in teams of two; one member entered the description and count of the items on the top portion of the perforated inventory tag; the second member verified the description and count of the items on the lower portion of the inventory tag, and then compared his recording with that of the first member.

The auditor and his assistants tested the inventory at the central warehouse and at the retail stores, and, after being satisfied with the accuracy of the inventory descriptions and physical count, ordered the lower portion of the tags removed and returned to the central office. At the central office, the description and count were transferred to classified inventory sheets. The items then were priced at the lower of cost or market, were reduced for damaged or obsolete merchandise, and extended and footed. The classified inventory sheets were then transferred to inventory summary sheets and were totaled by company employees.

Under the circumstances outlined, as an auditor, what procedure would you follow to verify the inventory? (AIA)

Problem 10–6. The AB Manufacturing Company manufactures a variety of products, which range in size and price from small and inexpensive articles to large and costly machines. Its operations are highly departmentalized and its manufacturing expenses are allocated to departments for each of which an overhead rate has been established.

Explain how you would satisfy yourself as to the correctness of the application of the manufacturing overhead in determining the cost of the various products manufactured and sold. (AIA)

Problem 10–7. A company manufactures a product called MZ which is in process for 30 days. Its ingredients are a variety of materials which are introduced into the production vats at established intervals. The resultant finished product is a liquid which at the completion of the process is drawn off into 100-gallon drums. Of the book value of the company's entire

inventory, approximately 20% is material, 75% work in process, and 5% finished product, all carried at "cost."

The company's records show that work in process is charged with materials put into process at cost, computed on the FIFO basis and that a flat charge per vat is made monthly to cover all other manufacturing costs which are incurred uniformly during the production period. Finished product is charged and work in process credited with the value of the liquid withdrawn at a standard cost per gallon. The company operates 90 vats, production in which is so staggered that approximately the same number of vats can be emptied each day. The company has not made any computations to support the amounts shown in the Work-in-Process account.

(*a*) State what detail record you would expect the company to maintain for controlling and costing this production process. (*b*) Outline a procedure for verifying the book value of the work-in-process inventory at the close of the company's fiscal year, excluding any consideration of physical inventory taking. (*c*) Either prepare an illustration of a work sheet or list the work sheet headings that you would use for assembling the principal data to be obtained for your verification. (AIA)

Problem 10–8. A company sells a patented device for use on railway locomotives. The device consists of several main assemblies which, in turn, comprise numerous subassemblies composed of many different parts. All materials entering into the device are purchased as finished parts, and the company's manufacturing operation is limited to their assembly. At the close of any day the inventory is in various stages of production, from purchased parts to finished devices. The different parts, subassemblies, and main assemblies have fixed production numbers, and are carefully segregated in bins plainly identified by those numbers. A perpetual inventory record, correspondingly numbered, is maintained in units and value. Production and sales are costed on the "last-in, first-out" method.

Several weeks before the balance sheet date you are requested by the company to suggest a plan for taking the inventory and arrange to make whatever verification you deem necessary in connection with your examination. Briefly outline the following: (*a*) the plan you would suggest to the client; and (*b*) auditing procedure you would follow for purpose of the examination. (AIA)

Problem 10–9. A client asks your advice with respect to the preparation of instructions to his staff for inventory taking and related work which you are to observe as independent auditor. What matters would you cover in your advice to him? (AIA)

Problem 10–10. What special procedures should an independent auditor adopt in the observance of inventory taking where large quantities of packaged materials are stacked in solid formation? (AIA)

Problem 10–11. Enumerate the features to be especially noted by an independent public accountant in the observation of a physical inventory, and state the purpose of such auditing procedure. (AIA)

Problem 10–12. Your client, a manufacturer with a large and active inventory, takes his raw-material inventory as of the close of business December 31 and "cuts-off" as of that date, but the inventory taking is not completed for several days thereafter. Describe your procedures with respect to the related incoming and outgoing material records. (AIA)

Problem 10–13. (*a*) Design an inventory tag and stub for use by a client conducting a moderate-sized wholesale plumbing material and supply business. (*b*) Write a memorandum of instructions such as might be necessary to instruct the client's employees in the use of the tag and stub. (AIA)

Problem 10–14. You are engaged in an audit of the records of the Amberly Company for the fiscal year ended October 31, 1954, and have observed the taking of the physical inventory of the company on that date. All merchandise received up to and including October 30, 1954, has been included in the physical count. The following lists of invoices are for purchases of merchandise and are entered in the voucher register for the months of October and November 1954, respectively:

Amount	F.O.B.	Date of Invoice	Date Merchandise Received
October 1954			
$ 3,600	Destination	Oct. 20	Oct. 22
2,200	Destination	Oct. 21	Oct. 23
925	Shipping point	Oct. 20	Oct. 30
3,975	Shipping point	Oct. 26	Nov. 5
2,500	Destination	Nov. 3	Oct. 29
1,025	Shipping point	Oct. 26	Oct. 30
8,600	Shipping point	Oct. 26	Oct. 30
10,251	Destination	Oct. 21	Oct. 30
3,457	Destination	Oct. 28	Oct. 30
November 1954			
$ 1,000	Destination	Oct. 29	Nov. 5
3,120	Destination	Oct. 30	Oct. 31
5,350	Shipping point	Oct. 28	Oct. 30
4,500	Shipping point	Nov. 1	Oct. 30
6,040	Shipping point	Oct. 26	Nov. 5
7,530	Shipping point	Oct. 28	Nov. 4
5,000	Destination	Oct. 28	Nov. 4

No perpetual inventory records are kept, and the physical inventory is to be used as a basis for the financial statements. (*a*) What adjusting journal entries would you suggest in view of the facts adduced? (*b*) What adjustments, if any, would you suggest to the physical inventory as originally taken? Prepare your solution in the form of a work sheet in good order showing all necessary verification of the amounts included. (AIA)

Problem 10–15. Your client, The Pram Corporation, manufactures baby carriages as its only product. The corporation maintains perpetual inventory records in quantities and values and also takes a complete physical inventory each October 31. You observed the physical inventory at October 31, 1954, and were satisfied with the procedures followed. From your test counts you are satisfied that the client's counts were substantially accurate. There were differences between the client's counts and the perpetual inventory records for about 75% of the items. Before adjusting the inventory records for the larger differences, of which there were about 25, the records were checked and the items were recounted. Typical examples of adjustments for the larger differences are:

Description of Item	Perpetual Record before Adjustment	Perpetual Record after Adjustment
Black paint (in gallons)	662	647
Cotter pins (in dozens)	2,260	2,160
Hub caps	8,592	8,708
Assembled wheels	6,901	6,883

The Pram Corporation made no further physical tests of inventories during 1954. For its year-end closing at December 31, 1954, the corporation used inventory quantities shown by the perpetual inventory records. Prepare in outline form an audit program setting out the essential procedures to be followed in your audit of inventories as of December 31, 1954. Do not include procedures unless you believe them to be essential under the conditions as stated. (AIA)

Problem 10–16. The Stevenson Supply Company normally adds 40% to the cost of all merchandise it handles. Most of the business is done through the main store, but a branch was opened a few years ago and appears to be developing satisfactorily. As there are no adequate warehouse facilities at the branch, only a small inventory is carried there.

In reviewing the income statements of the Stevenson Supply Company for the last few years you discover the following data. Is there anything in them to suggest additional investigation? If so, what would be the nature of that investigation?

	1954		1953		1952	
	Main Store	Branch Location	Main Store	Branch Location	Main Store	Branch Location
Sales (net)	$880,000	$225,000	$920,000	$190,000	$840,000	$140,000
Inventory, Jan. 1	320,000	65,000	240,000	60,000	250,000	50,000
Purchases (net)	665,000	162,000	733,000	147,000	586,000	111,000
	985,000	227,000	973,000	207,000	836,000	161,000
Inventory, Dec. 31	360,000	62,000	320,000	65,000	240,000	60,000
Cost of sales	625,000	165,000	653,000	142,000	596,000	101,000
Margin on sales	225,000	60,000	267,000	48,000	244,000	39,000

Chapter 11

VERIFICATION OF INVESTMENTS

To avoid carrying excess amounts of cash over slack buying seasons of the year, or to accumulate a secondary reserve in case of need, many concerns invest excess cash temporarily in bonds or shares of stock of other companies. These investments in other companies and transactions affecting them entered into throughout the period under examination should be verified by the auditor in order to determine the reliability of the accounting statements and records. Few verification problems offer as good an opportunity for an auditor to satisfy himself as completely as does that of investments. If reasonable precautions are taken in the performance of his tests, an auditor can be almost completely sure that the statements and accounts are correct in this regard, far more sure than he can be for such items as inventory or accounts receivable.

Verification Techniques Applicable in the Examination of Investments. Although at first thought the problems of examining investments may appear considerably different from those to be met with in the examination of receivables or inventories, more careful consideration will indicate that here as elsewhere the same basic techniques are useful. To ascertain that a company owns certain securities, that they are appropriately valued and described in its accounts and reports, and that transactions in securities during the period have been properly recorded requires some of the same techniques we have found useful in other situations. It seems obvious that the security certificates should be called for, examined carefully, and counted (physical examination and count), that valuations used by the company should be checked against market quotations (correlation with related information), and that documents evidencing transactions entered into should be scrutinized. If income from investments is to be checked, as it should be, recomputation and the retracing of bookkeeping procedures must be applied. Thus the clue to program development for investments as for other verification problems is found in matching the basic techniques to the information to be verified. Evidence must be obtained to support or

disprove the information as given. Application of the basic techniques is the means by which such evidence is obtained. The first step then is a determination of the type of evidence required. From that it should be possible to select the verification technique or techniques that will supply such evidence. Finally, the specific procedure to apply the techniques in the given circumstances must be set out.

This last step requires both experience and imagination. One must have an acquaintance with the practices and possibilities of business to visualize the specific application of the techniques required and sufficient imagination to meet new and different situations. Fundamental, however, is a knowledge of the types of evidence available through application of the basic techniques. The student who is content to memorize audit programs presented in textbooks or other sources has not equipped himself to meet new audit situations. The person who has a sound understanding of audit evidence and the means by which it may be obtained is much better prepared to deal with unfamiliar problems.

Essentials of Verification Procedure. As with notes receivable, the verification of investments can be worked into a controlling work sheet (or, if there is more than one class of investments, into a series of similar work sheets) that permits the auditor to examine at the same time the securities composing the balance of the account, the transactions during the period that result in the account balance, and related income and accrued interest accounts. In this chapter the essential steps in the verification program will be discussed, and then the method of working these into a work sheet illustrated. An auditor must satisfy himself that the securities or investments a concern claims to own are actually possessed by the company, that transactions during the period have been properly accounted for, that the securities are valued fairly in the financial statements, and that income from them has been properly accounted for. To do this the following steps are necessary:

1. Examine and count all securities on hand (simultaneously with cash and any other negotiable instruments).
   A. If securities are not available for count because in the hands of others for safekeeping or for any other reason, their existence and ownership by the company should be verified by confirmation.
   B. In examining or confirming the existence of the company's investments, the possibility of any being pledged as security for loans should be kept in mind. Such pledging requires disclosure in the

financial statements and may lead to discovery of unrecorded or unauthorized transactions.

2. The total of securities counted or confirmed should be agreed with the balance of the amount shown in the balance sheet or in the general ledger account.
3. Transactions in securities entered into during the period should be verified by reference to documentary evidence, the propriety of the accounting should be reviewed, and the entries tied in with the beginning and ending balances of the general ledger account.
4. The appropriateness of the company's valuation of investments should be tested by comparison with current market quotations where available or by such other evidence as can be obtained.
5. The classification and description of the securities for balance sheet purposes should be reviewed critically.
6. Income for the period from the investments held during the period should be determined independently of the company's records and traced into cash receipts and bank deposits.
7. Any related accrued interest should be verified by computation and tied in with the interest income accounts.

Examination and Count of Securities. Because securities can be sold and purchased readily and thus used to provide funds for substitution to cover a shortage of cash or other securities, the count of securities must be made simultaneously with the count of cash and other negotiable paper. The necessity for counting in the presence of the custodian and of obtaining a receipt for the return of the securities to the custodian should be apparent.

If preliminary arrangements can be made, it is well to have a list of the securities which should be on hand prepared in advance of the count. In order to facilitate the count and to assure that no important matters are overlooked, the list should include all pertinent details to be verified by the person examining the securities.

Securities are frequently kept in a safety deposit box with access to the box requiring signature by at least two officials. This may make it somewhat awkward to count securities on the same day as the cash because of the difficulty of having both officials on hand when the auditor is ready for his count. This difficulty can be eased if the auditor will request the company to refrain from opening the box until he can be present. If they will cooperate in this respect he has the advantage of simultaneous count and at the same time can wait on their convenience

before requesting access to the safety deposit box. To prove that his count has been simultaneous under such conditions he should obtain a letter or other statement from the company operating the safety deposit vaults stating that the box had not been opened from the date of the cash count when the company agreed to leave the box unopened until the date he was on hand to count the securities. Without such a statement, control and the advantages of simultaneous count have been lost.

In counting and examining the securities one should make sure that they are made out in the name of the company or have been indorsed to the company. All other pertinent details as indicated in the work paper, Illustration 18, should also be verified by inspection.

Some concerns turn their permanent investments, and sometimes temporary ones as well, over to a bank or other financial institution for safekeeping. If this is the case the auditor must rely on the confirmation procedure to assure himself that the company under examination does actually own the securities it claims. In examining or confirming securities, special attention should be given to the serial numbers of the certificates. Any change in serial numbers indicates that transactions were effected. If the records do not support this, the auditor may have discovered either unrecorded or unauthorized transactions.

The necessity for relating the total of securities counted and confirmed to the balance of the appropriate general ledger account or accounts is apparent. Most concerns carry investments at cost plus or minus any amortizations of discount and premiums, unless they have been adjusted for declining market prices. Some few concerns, however, do establish separate accounts for the premium or discount on securities purchased, a fact that must be taken into consideration in attempting to reconcile securities on hand with the balance of the investments account or accounts.

Transactions in Securities. Most transactions in securities are made through brokers or dealers who supply the company with a statement of the transaction known as a "broker's advice." This is nothing more than a specialized form of purchase or sales invoice, as the case may be, and will give a description of the security involved, the number of shares, the serial numbers of the certificates, their par or face value, and the price at which the transaction took place, including accrued interest if any. As security transactions are generally of material significance individually as well as in total, each transaction should be verified by reference to the broker's advice or other document which supports it. At the same time the auditor should note all the information given on

the broker's advice to make sure that the transaction was recorded as it should be and, if the entry was in error, should determine what adjustment is required.

Valuation of Investments. It is common practice to value marketable securities carried as current assets at the lower of cost or market. Permanent investments, whether marketable or not, are generally carried at cost unless an apparently permanent decline in their value seems to warrant adjustment to a more realistic basis. To determine the necessity for any adjustments of this nature it is necessary to refer to published market quotations of investments held and to compare the company's book value with the current value as indicated by published reports.

In adjusting to the lower of cost or market, accepted practice requires no adjustment unless the total market value is less than the cost of all investments within the given class. That is, the lower of cost or market rule is not applied to each individual security held. Nevertheless, if any individual investments have a market value considerably below their cost it is ordinarily considered wise to write them down whether the loss is compensated by increase in the market value of other securities held or not.

If securities of small or closely owned companies are held there may be no published quotations available to indicate whether adjustment is or is not advisable. If so, an auditor must rely on whatever information is available to him. Audited statements of the company whose securities are owned provide a reasonable basis for calculating book value as a guide to be supplemented by a review of the concern's earnings record. If audited statements are not available, unaudited reports must be used but they do not give as reliable a basis for evaluation.

Classification of Securities in the Balance Sheet. It is not the purpose of a textbook on auditing to discuss the appropriate classification of items within a balance sheet, and students are referred to any good intermediate accounting text. The point should be made, however, that the distinction between current assets and other assets is of fundamental importance in balance sheet preparation. The current ratio and the total current assets figure are used in various ways in credit granting and control, in determining when the concern can pay dividends, in the provisions of bond indentures to protect bondholders, and in general financial management. For this reason the auditor must insure that his work papers contain sufficient information for him to judge whether or

not the company's classification and description of investments satisfy the requirements of good accounting practice and of full disclosure.

Income from Investments. Receipts of income from investments are somewhat different than those from cash sales or collections on account and frequently are not as adequately protected by internal control measures. It is therefore required that an auditor first establish what income

[illegible] Company
Investments – Account #110
12/31/54

	Int Dates	No	Par or Face	Per Audit 12/31/53	Investments Purchased	Investments Sold
Bonds						
A Company First Mtge., 4%, 1965	Feb + Aug	10	1,000.00	9,700.00		
D Company Gen'l Mtge, 5's Series B, 1960	May + Nov	26	500.00	13,000.00		10/1 6,500.00
M Company, Debentures, 3½%, 1964	Mar + Sept	8	1000.00	7,680.00		10/1 7,680.00
D Company, Debentures 4's, 1981	Jan + July	4	1000.00	3,900.00		
				34,280.00		14,180.00
Stocks						
C Company Common		60	50.00	2,850.00		
F Company 6% Preferred		100	100.00	11,600.00		
T Company 5% Preferred		20	100.00	2,850.00		10/15 2,850.00
Y Company Common		30	none		2/15 2,650.00	
				17,300.00	2,650.00	2,850.00
				51,580.00	2,650.00	17,030.00

Gain on Sale of Securities

	Date Sold	Book Value	Sales Price	Gain or Loss
D Company Gen'l. Mtge Bonds	10/1	6,500.00	6,700.00	200.00
M Company Debentures	10/1	7,680.00	7,920.00	240.00
T Company Preferred Stock	10/5	2,850.00	2,700.00	(150.00)
		17,030.00	17,320.00	290.00

T.B #90

Illustration 18. Work sheet

should have been received, and then trace the receipts into the cash receipts book and if necessary into duplicate deposit tickets to discover whether they have been entered and accounted for properly.

If the investments are bonds, mortgages, or any security having a fixed rate of interest the auditor should compute the interest earned during the period under examination and then, by reference to the dates interest is paid under the terms of each bond, examine the cash receipts book to

		Interest				
Balance 12/31/54	Market Value 12/31/54	Per Audit 12/31/53	Purchased	Earned	Collected	Balance 12/31/54
9700 00 ✓	10400 00	166 67 ^		400 00 c	2/1 200 00; 8/1 200 00	166 67 c
6500 00 ✓	6700 00	108 33 ^		568 74 c	5/1 325 00; 11/1 162 50; 10/1 135 40	54 17 c
-0-		70 00 ^		233 33 c	10/1 23 33; 3/1 140 00; 9/1 140 00	
3900 00 ✓	3850 00	80 00 ^		160 00 c	1/1 80 00; 7/1 80 00	80 00 c
20100 00	20950 00	425 00		1362 07	1486 23	300 84
		425 00		1362 07	1486 23	300 84
		Dividends Paid		Accrued interest on notes receivable Anal. 8		
2850 00 ✓	2900 00	4/15 240 00				248 50
1160 00 ✓	1120 00	1/15 300 00; 7/15 300 00		See Anal. 13		549 34
-0-		10/12 100 00				T.B. #9.4
2650 00 ✓	2650 00					
17100 00	16750 00	940 00				
37200 00	37700 00	940 00				
	T.B. #10.2	T.B. #90.4				

^ Per 12/31/53 audit work papers.
✓ Certificates examined in presence of Wm. Morrell 1/2/55
x Approved per B/D minutes. See permanent file, Analysis Q.
h Broker's advice examined; transaction recorded correctly.
⇜ Traced to cash receipts book.
c Correct per our calculation.
* Plus accrued interest.

Company does not amortize premiums or discounts on investments.

(9)

for investments.

find whether the interest was actually received and entered. The interest income calculated in this way should be reconciled with the beginning and ending accrued interest so that the auditor has a complete record of the income from each bond investment based on his own computations and the interest rates and dates stated in the bonds themselves.

If the investments are stocks having no fixed or required return, computation by the auditor is impossible. There are available, however, published stock records which list all major issues in the United States and foreign countries together with the dividends paid for any given year. By reference to such a stock record an auditor can readily determine how much and when dividends were paid and can then search the cash receipts book for the entries that should be there.

In some cases a company will hold stock in another company that is not included in any published dividend record. If so, correspondence with the company whose securities are held may be necessary to establish the amount of dividends that should have been received and deposited.

Work Sheet for Verification of Securities. None of the verification procedures discussed in this chapter offer any very difficult problem either in intent or in application. If the verification assignment is a repeat engagement of one performed at a previous date, the work papers for successive years can make up a continuous record of investment transactions and balances together with the verification thereof. The work sheet illustrated is prepared on that assumption.

This particular form of work sheet is extremely useful in facilitating verification; it does have some limitations with respect to providing for adjustments. Therefore, if a preliminary survey of the investments account indicates a great many errors it may be desirable to use a work sheet with money columns headed as follows:

Column	
1	Balance beginning of year
2, 3	Transactions per company records
4	Balance at end of year per company records
5, 6	Audit adjustments
7	Balance per audit end of year

Additional columns for interest and dividends as desired.

PROBLEMS—CHAPTER 11

Problem 11–1. (*a*) The balance sheet of a company operating a large number of retail stores shows among the assets an item "leases" of relatively considerable amount. 1. What would this item normally represent, and how should it be shown on the balance sheet? 2. How may the amount be verified?

(*b*) How should a portfolio of marketable securities be inspected in a first audit of a manufacturing company? (AIA)

Problem 11–2. A considerable number of first mortgages on local real estate are held by an institution. How should they be checked and examined from year to year and the income confirmed? (AIA)

Problem 11–3. Give a procedure for the verification of the transactions in a sinking fund for the redemption of bonds, where the fund is in the custody of an independent trustee. (AIA)

Problem 11–4. During the year under review a charitable institution received a specific bequest in the form of an endowment fund composed of mortgages and coupon bonds with all unpaid interest coupons attached. The securities were immediately turned over to the custody of a trust company, which has since credited the institution's account with interest collected and with the proceeds of bonds sold or redeemed. Such proceeds were promptly reinvested in bonds, some of them purchased at a premium and others at a discount. The executors furnished a list of the market value of the separate securities as of the effective date of the bequest, and the values so stated were verified by the trust company. All mortgages were valued at their principal amount. Outline an audit procedure for the examination of this fund. (AIA)

Problem 11–5. Outline a procedure for the verification of bank certificates of deposit owned at the balance sheet date, and state how they should be shown in the balance sheet. (AIA)

Problem 11–6. A corporation temporarily invested some of its excess funds in stocks of other companies listed on established exchanges. In the course of your preliminary audit work you ascertain that all such stocks were acquired at various dates during the year under examination through a brokerage firm, and the stock certificates are in the name of the corporation under examination but are being held in safekeeping by the brokerage firm referred to. The corporation does not maintain an investment ledger. You are requested to outline the audit procedures for the examination of stocks and income therefrom as reflected on the books of the corporation. (AIA)

Problem 11–7. To what points should the auditor direct his attention in the examination and verification of bonds and mortgages held as an investment?

Problem 11–8. Prepare a detailed audit program showing step by step what audit procedures you would follow in making an examination in which one of the most important phases involves marketable securities of substantial value, including stocks, bonds, and mortgages. For the purpose of this question, give in detail the section of your program covering your audit of these investments. (AIA)

Problem 11–9. Based on the data below, (*a*) prepare a columnar work sheet analyzing the account for the year showing transactions, adjustments, and final balances at September 30, 1954. (*b*) Journalize such adjustments as are needed to correct the investment account of the F Company at September 30, 1954. In an interim examination of the accounts of the F Company for the calendar year 1954 you find the Investment Account as follows:

Date		Ref.	Debit	Credit
Jan. 1	Balance brought down		$108,936	
Jan. 31	Sold *A* stock	CB		$10,682
Mar. 31	Bought *B* common	VR	12,125	
June 30	Dividend on *C* common	J	10,000	
July 31	Sold *C* common	CB		8,750
Aug. 31	Sold *D* bonds	CB		22,500
Sept. 30	Interest on *E* mortgage	CB		350

Reference to the audit working papers of the preceding year shows that the balance at January 1, 1954, consisted of the following:

A Company common	
1,000 shares bought in June 1940 at $10 a share	$ 10,000
2,000 shares bought in August 1942 at $8 a share	16,000
1,500 shares bought in May 1945 at $11 a share	16,500
B Company common	
2,000 shares bought in January 1946 at $16.50 a share	33,000
C Company common	
100 shares bought in August 1941 at $73 a share (par $100)	7,300
D Company 5% general mortgage bonds	
Twenty $1,000 bonds bought July 1944 at 98.4 (interest dates F & A)	19,680
E Company chattel mortgage on machinery	
5%, $7,000 mortgage taken in September 1947 in settlement of account receivable	6,456
	$108,936

Your examination discloses the following:

In January 1954, 1,000 shares of the *A* Company common stock bought in May 1945 were sold for $10,682, net of brokerage.

In March 1954, 500 shares of *B* Company common stock were bought at $24 a share plus brokerage for $12,125.

In June 1954, the *C* Company paid a 100% stock dividend—common on common.

In July 1954, the *F* Company sold to its president, for $125 a share, 100 shares of *C* Company common stock for which the president gave his check for $8,750 and a letter in which he agreed to pay the balance on demand of the treasurer of the company.

On August 1, 1954, the *D* Company redeemed its 5% general mortgage bonds at 110 plus accrued interest.

In September 1954, the *F* Company received one year's interest on the $7,000 chattel mortgage of the *E* Company which it holds. (AIA)

Problem 11–10. The "Marketable Securities" account of the Lane Company appears as follows for the year 1954:

Marketable Securities

1/1/54	Forwarded	$2,350.00	9/11/54	$ 650.00
6/3/54		4,762.50	11/30/54	4,762.50

From your examination of pertinent documents, you discover the following:

1. The opening balance was composed of:
   25 shares of *Y* Company preferred purchased at $42 a share.
   20 shares of *T* Company common purchased at $65 a share.
2. On March 15, the company received five shares of *T* Company common as a stock dividend. Market value of *T* Company common shortly after declaration of this dividend was $73 a share.
3. On June 3, the company purchased five *LC* Company 5% bonds, par value $1,000 each, interest dates March 1 and September 1, due March 1, 1965, for $4,762.50 including accrued interest.
4. On September 11, ten shares of *T* Company common were sold at $75.
5. On November 30, the *LC* bonds were sold for $4,750 plus accrued interest.

Required: An analysis of the "Marketable Securities" account in good form including an indication of the verification work you would have performed on the job, and any adjusting entries you feel are necessary to correct the accounts as stated.

Chapter 12

OTHER ASSETS AND RELATED TRANSACTIONS

In the verification of current assets, and of long-term investments as well, an auditor is chiefly concerned with the possibility of overstatement of the final balance or of failure to detect and record transactions during the year. Once the verification work on the current asset section has been completed and that on other assets and their related transactions taken up, he must change his point of view somewhat. The danger becomes not so much one of overstatement or of failure to detect and record transactions, although those are always possibilities, as it becomes one of failure to account for transactions in accordance with sound accounting practice.

There is relatively little opportunity for defalcation or fraud in connection with the fixed assets or deferred charges of the ordinary manufacturing or merchandising company. There is a good chance, on the other hand, that through failure to recognize the real nature of a given item or transaction an entry will be made that does not reflect the facts of the situation. Thus a concern may fail to distinguish properly between additions to its fixed assets and expenses, or may fail to consider prepaid insurance as an asset. It is with errors of this type that an auditor must concern himself most when dealing with the large variety of assets that may be called "non-current."

FIXED ASSETS

Fixed assets often make up a considerable portion of a concern's total properties and may consist of a considerable variety of kinds of asset. From the point of view of verification, however, all present about the same problem. In most cases the transactions during the year which affect or which might affect fixed asset account balances must be carefully reviewed to ascertain that appropriate entries have been made in view of the nature of the transaction. To achieve this, it is necessary to understand the related nature of the accounts which must be included within the group of accounts making up the fixed asset verification problem.

As a general practice, the fixed asset accounts, related repair and maintenance expense accounts, related accounts for depreciation expense and accrued depreciation, and any accounts for gains and losses on the sale or retirement of the fixed assets must be considered as a group in working out the verification program. The interrelationship of these various accounts is apparent if one gives some consideration to the content of each. Repair and maintenance accounts might be charged for items more properly considered to be additions to the fixed asset accounts; hence they must be verified in connection with the verification of additions to the fixed asset accounts. The ownership of fixed assets implies the necessity for consideration of depreciation expense, and this in turn points out the importance of considering the reserve for depreciation or other account used to accumulate the depreciation charges over a period of years. When assets are retired, the accrued depreciation account is affected and must be given consideration in calculating any gain or loss on the transaction. Thus all these accounts are related and should be considered together.

Objectives of Verification of Fixed Assets. Included within the verification program for fixed assets and related transactions should be the following responsibilities of the auditor:

1. To satisfy himself as to the substantial existence of the fixed assets included in the account balances.
2. To satisfy himself that title to the assets included in the account balances is vested in the company under examination or that if not so vested because of hire-purchase agreements and the like that the opposing liability is satisfactorily disclosed.
3. To verify the propriety of fixed asset transactions during the year by reference to documentary evidence or such other evidence as is available.
4. To determine whether required approval has been obtained for all significant fixed asset transactions.
5. To review depreciation entries, calculations, and rates for the period.

Audit Procedures for Fixed Assets. Because fixed assets vary so much in structure and use from company to company and also within a given company it is not practicable to attempt to set out a list of detailed procedures applicable to their verification. The following list of

procedures, therefore, can indicate in only a general way the steps that may be taken to achieve the audit objectives stated above.

1. Determine existence of assets by physical examination to the extent practicable and reasonable in the circumstances.
2. Examine invoices or contracts for acquisitions during the period.
3. Obtain a confirmation from the company's attorneys as to present existence of title to major fixed assets.
4. Review minutes or by-laws for appropriate authorization of transactions entered into during the period.
5. Trace property retirements to subsidiary property records and verify charges to depreciation accruals by recomputation.
6. Review depreciation rates for reasonableness and consistency with prior years. Verify current provisions by calculation and reconcile amounts charged to expense with increases in accrued depreciation accounts.

Existence of Fixed Assets. It has already been pointed out that an auditor is seldom an expert in the materials making up inventories he is called on to verify. In the same manner he is seldom an expert on machine tools, land and buildings, or office equipment. Yet he still has a responsibility and one that he can discharge reasonably well within the limit of his capabilities.

It is unlikely that any minor errors as to the existence of fixed assets will have any significant effect on the general reliability of accounting data. In most cases it would require a relatively important discrepancy to be of material significance. Hence, there is little or no need for an auditor to require a physical inventory of fixed asset items except in unusual circumstances. In most cases all that is required is that he see for himself that the concern under examination does have the types of fixed assets it claims, in roughly the quantities claimed.

On almost every audit engagement it is possible for the audit staff, or at least those concerned with the verification of fixed properties, to arrange for a tour through the offices and plant. During the course of such a tour, it is generally possible to see enough to satisfy oneself as to the substantial existence of the assets claimed by the company in its accounts. If questions later arise as to the existence of specific items of property or of recent additions to the fixed assets, it is entirely reasonable for the auditor to request that those particular items be pointed out to him. Other tests are used to support the amount of each addition to

the fixed asset accounts. At this stage all that is intended is that the auditor satisfy himself that some addition was made or that fixed assets adequate to the needs of the company are present.

Title. Verification of the title to fixed assets could be an extremely burdensome task if a serious effort were made to prove title to all fixed property. This is seldom necessary. Usually the presence of fixed assets on the company premises is sufficient evidence that the company does own the equipment. For new additions this is further supported by reference to purchase invoices. A more serious problem may arise in regard to land and buildings for which there is always some danger of unrecorded sale and lease-back agreements. Few auditors are qualified to make a search of public records for such transactions, and unless there is real suspicion of such a transaction there is little need to employ someone more qualified to make such a search for the auditor. In most cases it is a safe assumption that no such transactions will be entered into without consultation with the company's attorneys. Hence, it is desirable to obtain a confirmation from the company's lawyers to the effect that in so far as they are aware the title to the land and buildings remains in the name of the company and that no transactions in which these properties have been used as security for loans or other obligations have been entered into during the year.

A confirmation of this type can frequently be combined with a request for information as to the existence of unrecorded real or contingent liabilities discussed in Chapter 13.

Verification of Transactions During the Period. In as much as most audit engagements are repeat engagements of examinations made in previous years, it is commonly possible to accept the balance of the fixed asset accounts at the beginning of the year as correct. Attention is then directed to the transactions recorded during the period under examination.

It should be accepted without question that transactions immaterial in amount are seldom verified in detail. It may be desirable to test a portion of such transactions, but for most purposes the verification of fixed asset transactions can be restricted to those of material amount.

When several transactions have been recorded in a given asset account during a period, an analysis of that account should be prepared commencing with the opening balance and including the detail of additions

and retirements during the period together with sufficient reference material on each addition that the invoice record of purchase may be located as evidence of the propriety of the transaction and of its entry. Once the analysis has been prepared, the task of locating the required invoices can be left to one of the company's clerical workers, if such arrangements can be made, and time of the audit staff thus conserved.

In examining the documents supporting the entries in fixed asset accounts, an auditor must satisfy himself that the transaction which the document purports to represent is a legitimate one, that the company under examination was billed for it, that the invoice has received the approvals required for its acceptance for payment, and that the entry made to record the invoice is correct. The question to be answered is: Should this particular item be charged to this account for this company? Unless that question can be answered in the affirmative an adjustment of some kind is in order.

If the company follows a practice of constructing its own fixed assets, the simple procedure of referring to a purchase invoice for verification of an addition will not be available. However, the company will have some record of the costs incurred in construction of the asset. From this record the auditor can work back to time cards of employees assigned to the construction project in support of labor charged, to material requisitions or material purchase invoices for material used, and can review the burden rate used to assure himself that it is in line with the concern's regular burden rate and is reasonable in the circumstances. The verification here compares very closely with that required for verification of work-in-process inventories.

Credits to fixed asset accounts are somewhat more difficult of verification than are debits. Unless a concern has a sound procedure of internal control over fixed asset retirements, it is possible that a machine or other item of equipment might be retired and discarded with no entry whatsoever. Such obsolete equipment is sometimes sold for scrap and the scrap sale may give a clue as to the disposition of the asset, but often it is merely discarded or sold together with scrap from the manufacturing process. In preparing his work program, an auditor must take special note of the extent of the internal control over fixed asset retirements, and if it is at all inadequate must attempt to cover that deficiency in some manner. Complete lack of internal control on this score might suggest the necessity for an inventory of the fixed asset items. Careful inquiry of department heads concerned should be made, and it might be

in order to request statements from them as to any major retirements during the period under examination.

If fixed asset detail ledgers are kept, and this is usually required for income tax purposes if for no other reason, the amount of depreciation accumulated on the asset at date of retirement must be determined and kept in mind in judging the propriety of the entry made to record the retirement. This is largely a matter of correct accounting entry and requires a sound knowledge of accepted accounting principles on the part of the auditor.

In addition to a review of the propriety of all entries in the fixed asset accounts, a similar review should be made of all entries in any related repair and maintenance accounts. The same type of analysis is required for these accounts to assure the auditor that no fixed asset items have been incorrectly charged to an expense account. This has become of particular importance since high income taxes have encouraged the overstatement of expenses rather than of assets. Again, the invoices must be obtained and examined with a view toward determining the appropriateness of the entries made.

Approval of Fixed Asset Transactions. The by-laws of many companies require that all fixed asset transactions of consequence are to be considered and approved by the board of directors before their consummation. An auditor must determine the requirements of the by-laws and of the accounting manual of any company under his examination and by appropriate testing and reference to minutes of directors' meetings or other records determine whether requirements are satisfied.

Depreciation Provisions. It is the duty of the auditor to determine whether depreciation is being charged on depreciable fixed assets and to satisfy himself that the charge is reasonable, that is, neither excessive nor insufficient. He must review the depreciation calculations of the company to discover any arithmetical errors or other errors in the application of the rate to the correct base, and must scan the depreciation entries to assure himself that the accounts used are appropriate to the purpose.

Determining or reviewing the adequacy of depreciation provisions is a technical and difficult matter. To a considerable extent, an auditor has responsibility only to determine that the rate used is reasonable, not accurate to the last degree. If a concern has rates established by engineers, which are not out of line with its own past experience or with what the auditor knows to be the experience of others in the same line of

business, there is little reason to question the rates so long as they are applied uniformly year after year. If, on the other hand, the concern has a considerable amount of fully depreciated property still in use and if its rates seem higher than those of other companies with similar assets, there may be reason to revise depreciation estimates downward. If retirements of assets always find an undepreciated balance well in excess of scrap or salvage values there may be a need for revisions of depreciation rates upward. Once rates have been carefully established, an auditor has a responsibility to see that they are applied properly and changed if they appear seriously out of line. Beyond that there is little he can do.

The depreciation reserve or accrued depreciation account presents no great problem but should always be analyzed in connection with depreciation expense. The depreciation expense for the year should make up the credit to the depreciation reserve account or accounts, and this should be carefully determined. The accumulated depreciation on assets retired should be charged against the reserve account, and unless there is a major adjustment of depreciation these should be the only entries in the account. Any other entries should be carefully reviewed and the authority for them verified.

Work Sheets for Fixed Asset Verification. A variety of work sheet forms for use during the verification of fixed assets and related transactions may be helpful depending on the task to be accomplished. The common form of account analysis for a fixed asset account is shown in Illustration 4 and for a related reserve for depreciation in Illustration 5. These should be studied in relation to the verification steps described. A summary sheet for all fixed assets is sometimes prepared to bring together in one place all fixed asset accounts with their related depreciation accounts and audit adjustments in order to facilitate review of the audit work. Such a summary or "lead sheet" as it is sometimes called is illustrated in Illustration 19.

Illustration 20 shows a simple form of work sheet used by auditors to compute depreciation year after year for a situation in which inadequate records are kept by the company or in which for some other reason, the auditor feels that he should have a complete record of depreciation in his own work paper records.

Verification of Fixed Assets in a First Audit. The discussion in this chapter has assumed that previous audit examinations of the company's records had been made by the same auditor. If, however, an auditor

Clement Company
Fixed Assets and Accrued Depreciation
December 31, 1954
Fixed Asset Accounts

	Work-sheet No	Per Audit 12/31/53	Additions	Retirements	Per Books 12/31/54	Audit Adjustments
Land	17	65,000.00			65,000.00	
Buildings	18	387,500.00			387,500.00	
Machinery + Equipment	19	448,000.00	17,850.00	12,800.00	453,050.00	① (1,800.00)
Delivery Equipment	20	96,000.00	24,000.00	16,200.00	103,800.00	
Office Equipment	21	44,000.00	385.00		44,385.00	② 140.00
		1,040,500.00	42,235.00	29,000.00	1,053,735.00	(1,660.00)

① A.J.E. #14 to record retirement of lathe not entered - see Analysis (19).

② A.J.E. #17 to record typewriter charged to expense - see Analysis (20) and (46).

Illustration 19. Summary work sheet for

makes his first examination after the company has been in operation for a long period of time it becomes necessary that he satisfy himself as to the opening balance of the fixed asset and reserve accounts in addition to the transactions for the year under examination.

Various methods of accomplishing this are available. If the transactions in the fixed asset accounts are relatively large in amount and

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Accrued Depreciation Accounts

Per Audit 12/31/54		Per Audit 12/31/53	Depreciation Expense	Retirements	Per Books 12/31/54	Audit Adjustments	Per Audit 12/31/54
65000.00		-0-			-0-		-0-
387500.00		118400.00	9600.00		128000.00		128000.00
451250.00		186300.00	43900.00	12800.00	217400.00	(1800.00) 1	215600.00
103800.00		43200.00	10100.00	13600.00	39700.00		39700.00
44525.00		16800.00	2300.00		19100.00		19100.00
1052075.00		364700.00	65900.00	26400.00	404200.00	(1800.00)	402400.00

Depreciation charged as follows:

Acct. No	110	53500.00
	127	10100.00
	147	1700.00
	158	600.00
Total as above		65900.00

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fixed assets and accrued depreciation.

few in number, it may be desirable to verify each one by reference to documentary evidence and by inspection of the asset as well. This, of course, assumes that the needed documentary evidence has been retained by the company. In other cases where transactions are extremely numerous, it may be sufficient to review the bulk of the transactions and to verify by reference to documentary evidence only the more important

Robinson Company
Depreciation on Delivery Equipment
Rate - 10%, ½ rate in year of acquisition + retirement

No.	Description	Date Acquired	Cost	1950	1951	1952
1	Ford pick-up truck	4/30/50	1880 00	94 00	188 00	188 00
2	Jeep	4/30/50	1720 00	86 00	172 00	172 00
3	International	4/30/50	3020 00 6620 00	151 00 331 00	302 00	302 00
4	International	7/1/51	3140 00 9760 00		157 00 819 00	314 00 976 00
5	International	9/9/53	3080 00			
6	Plymouth station wagon	12/12/53	2340 00 15180 00			
7	Chevrolet truck	2/16/54	3300 00 18480 00			
	Depreciation for the year			331 00	819 00	976 00
	Accrued depreciation Jan. 1			-0-	331 00	1150 00
	Accrued depreciation Dec. 31			331 00	1150 00	2126 00

Illustration 20. Work sheet for

transactions. Depreciation computations and entries likewise must be reviewed and their general reasonableness ascertained. Whatever the degree of verification chosen it should be clear that some work, sufficient to satisfy the auditor as an independent professional expert, is required before he can accept the opening balance in the account.

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1953	1954	1955	1956
18800	18800		
17200	17200		
30200	30200		
31400	31400		
15400	30800		
11700	23400		
124700			
	16500		
	168300		
124700	168300		
212600	337300		
337300	505600		

depreciation on delivery equipment.

INTANGIBLE ASSETS

If the accounting for intangible assets is fully understood, their verification is not a difficult task. The auditor must satisfy himself that the asset does exist and is owned by the company, and that it is properly described and accounted for in the accounts and financial statements.

This includes review of any amortization which should be recorded whether entered or not.

The existence of patents, trademarks, and the like can be verified by the examination of suitable documentary evidence such as letters patent or a registration certificate of a trademark. These are not entirely satisfactory, however, as transactions may have been entered into since the patent was granted or the trademark registered. Again it is desirable to confirm the existence of such properties with the company's attorneys as they are better qualified to describe the legal status of intangible assets than perhaps anyone else. Care should be taken in requesting a confirmation to obtain all pertinent details in respect to the asset in question including date of granting, legal life, and expected useful life.

The cost of any intangible having a limited life should be amortized over that life. An auditor should be alert to the type of intangible that is likely to have a limited life, including goodwill, and should review the amortization program in effect. If there is any question as to the adequacy of amortization charges, further investigation should be made and, if necessary, past and future amortization adjusted. In most cases the company's amortization plan is as reasonable as any the auditor could devise and there generally is little need for revision. This does not mean that all such provisions should be accepted as a matter of course. If there is real reason to suspect the propriety of any entries made by the company under examination an auditor must make further investigation and suggest adjustments as may be necessary.

It should be apparent without special comment that, if intangibles are acquired during the period under examination, reference should be made to any documentary evidence of the transaction including correspondence preceding and following the actual acquisition of the asset. Likewise, in a first audit there is required some examination of documentary evidence of all intangible asset acquisitions of material amount.

PREPAID EXPENSES

Although prepaid expenses are current assets they have been postponed for consideration until this point because they are seldom material in amount and because, from an audit point of view, they are more similar to deferred charges than to other current assets. For both prepaid expenses and deferred charges, an auditor has three points that must be covered:

1. He must satisfy himself that the item represents an actual expenditure in the amount claimed. This can best be done by reference to

documentary evidence of the transaction, invoices, receiving reports, insurance policy forms, and the like.

2. He must satisfy himself that the amount deferred may properly be carried as an asset. To do this he must vary his test with the nature of the item. If it is an inventoriable asset such as a supply item, he can examine the thing itself and perhaps make test counts and other tests of the company's inventory records as suggested for merchandise inventories. If it is not an inventoriable asset, it may be necessary to recompute any prorating such as for insurance policies, or to discuss with company employees their basis for carrying forward the amount shown. Such amounts are seldom material and therefore it is necessary only that the auditor be reasonably satisfied as to the approximate accuracy of the amount deferred.

3. The amount deferred and the amount written off during the period under examination should be tied in with, or related to, the associated expense account to ascertain if additional amounts should be deferred and to explain the composition of the expense account.

Prepaid Insurance. Among the most important prepaid expenses is prepaid or unexpired insurance. The importance of this asset lies not so much in its dollar amount as in its relation to the other properties of the company. Failure to insure other assets against risks inherent in their ownership or in the particular business may be an important factor in financial condition and one to which an auditor should give careful consideration.

The extent of the verification to be applied to unexpired insurance varies with the extent and accuracy of the company's records of insurance policies and their expiration. If the concern has an insurance record kept by a well-trained and careful employee it is possible that only some slight testing of this record will be required on the part of the auditor. If, on the other hand, the company keeps no insurance records at all and merely charges all premiums to either an expense or an asset account indiscriminately it may be necessary for the auditor to prepare a work sheet which in effect is a complete insurance register. In such a case he must work out the amortization for the period and the ending balances in detail, a long and time-consuming task. Needless to say, whenever possible he should rely on the company's work sheets or records if they are at all satisfactory.

Illustration 21 illustrates the type of work sheet that might be required if inadequate records are found. Note the tie-in with insurance expense.

Clement Company
Unexpired Insurance
December 31, 1954

Company	Policy Number	Property Coverage	Insured Against	Amount of Coverage	Date of Policy
Dakota Casualty	17-X-493	Bldgs	Fire & E.C.	3500 00	6/30/52
Illinois and Iowa	A-438927	Bldg. contents	Fire & E.C.	8000 00	12/1/52
Wisconsin Specialty	ALT-3986	Cash & sec.	Theft	500 00	10/1/54
Wisconsin Specialty	RC 2498	Bldg contents	Sprink. leak	8000 00	7/1/53
United	14-Z-139	Trucks	Comp. liab.	\$25,000 & \$50,000	12/15/54
Missouri Bonding	LC-4389	Employees	Indemnity Bond	50000 00	4/30/54
United	DA 3111	Workmen's Compensation		Statutory	9/2/54

See accompanying sheet for discussion of insurance coverage.

Prepaid Workmen's Compensation

Classification	Rate	Payroll to Date	Ins. Cost
Factory	.05 per \$100	680000 00	340 00
Delivery	.05 " "	124300 00	62 15
Office	.02 " "	245800 00	49 16
			451 31

Illustration 21. Work sheet

In addition to satisfying himself as to the reasonable accuracy of the balance of Prepaid Insurance and Insurance Expense, an auditor must make a careful review of insurance coverage in general. It is not expected that an auditor will be an expert in the field of insurance, but it is expected that he will have a reasonably comprehensive knowledge of the common business risks that can be insured against and the types of insurance available to protect the company under examination against

RLM
2-7-55

Expiration Date	Term	Cost	Balance 12/31/53	Premiums Paid	Amortization	Balance 12/31/54
6/30/55 ✓	3 yrs. ✓	1800 00 ✓	900 00 *		600 00 4	300 00
12/1/55 ✓	3 yrs. ✓	2400 00 ✓	1533 40 *		800 04 4	733 36
10/1/55 ✓	1 yr. ✓	48 00 ✓	10 50 *	48 00 x	10 50 4 36 00 4	12 00
7/1/56 ✓	3 yrs. ✓	240 00 ✓	200 00 *		80 00 4	120 00
12/15/55 ✓	1 yr. ✓	180 00 ✓	165 00 *	180 00 x	165 00 4 7 50 4	172 50
4/30/55 ✓	1 yr. ✓	66 00 ✓	22 00 *	66 00 x	66 00 4	22 00
9/2/55 ✓	1 yr. ✓	675 00	170 00 *	675 00 x	451 31 4	393 69
			3000 90	969 00	2216 35	1753 55

Insurance expense charged to:

Acct. # 114	1666 35
# 128	380 00
# 156	170 00
	2216 35

* Per our 12/31/53 work papers
✓ Policy examined
x Voucher and supporting invoice examined
4 Calculation of amortization verified

for unexpired insurance.

such risks. For example, if a concern has an extensive sprinkler system as protection against fire, an auditor should almost automatically consider the possibility of insuring against damage to inventory and equipment because of sprinkler leakage. If a company entrusts cash and securities to employees, as it must, in most cases, the importance of bonding such employees should be evident.

In reviewing insurance coverage an auditor must not only consider the

nature and number of risks to be provided for; he must also give some thought to the amount of insurance needed in each case. Fire is a definite threat to a building and, of course, some insurance is required. The auditor must satisfy himself not only that some fire insurance is carried but that the amount is adequate in view of the circumstances. This requires that he give attention not only to book values but also to current real values. Insurance companies permit recovery, if appropriate amounts of insurance are carried, to the extent of the actual value of the property lost. In a period of increasing production costs or of price level change, book values based on cost may bear very little relation to the sound value of the property. It is generally a good policy to begin with the book value of the assets as a starting point, but an auditor must certainly give consideration to other factors as well in determining the adequacy of insurance coverage.

Again it should be noted that the auditor is not responsible for stating exactly how much insurance should be carried. That is a problem for the management of the enterprise in consultation with its insurance agent or broker. The auditor's responsibility is only to make a reasonable review of the coverage, and, if it appears to him in any way inadequate, he should then recommend to the company management that immediate consideration be given to the problem. It is generally wise to put such recommendations in writing so that the auditor has a copy for his files in case of later question or difficulty.

DEPOSITS AND ADVANCES

Included among the assets of many companies are advance deposits with airlines, good faith deposits on contract bids, amounts paid in advance to special contractors or suppliers, advances to affiliated or associated companies, and the like. Often the verification procedure most applicable for such assets is that of confirmation. However, it is usually a sound procedure to refer to any documentary evidence available for any transactions taking place during the period under examination in order that the real nature of the transaction and of the resulting balance sheet item may be determined. A shortage could perhaps be covered by showing an account receivable from or a deposit with some company at an incorrect address. A confirmation sent to that address could be received by the party guilty of the shortage and returned by him apparently in good order. Examination of the canceled check or of vouchers for the original disbursement might indicate that this was an advance to an individual rather than to an associated company.

In requesting confirmation of balances, care should be exercised to confirm not only the original amount advanced but the amount standing to the credit of the company on the audit date.

Throughout the verification of asset account balances, consideration should be given to their classification for balance sheet purposes. Sufficient information should be collected during the verification procedure to permit accurate description and classification in any financial statements to be prepared.

PROBLEMS—CHAPTER 12

Problem 12–1. Outline the audit procedure in connection with capital expenditures and retirements of a fair-sized industrial concern that are controlled by a system of "authorizations." (AIA)

Problem 12–2. From the following transcript of "Insurance Account" and "note" covering unrecorded liability prepare (*a*) a columnar analysis showing proper distribution of debits and credits. Prepare therefrom (*b*) the entries that will adjust surplus, profit and loss, and other December 31, 1953, balance sheet items involved.

Insurance Account

1952

		Debits	Credits
July 2	Premium on fire insurance policy (building) covering period from August 1, 1952, to July 31, 1954	$2,400	
Aug. 15	Premium on fire insurance policy on stock of goods, period from August 1, 1952, to July 31, 1953	1,800	
Sept. 1	Premiums on employees' fidelity bonds, period from August 1, 1952, to July 31, 1953	3,000	
Oct. 25	Shortage of R. Jones to be reimbursed by Fidelity Insurance Company	900	
Dec. 1	Refund due to reduction in rate on fire insurance on building, period December 1, 1952, to July 31, 1953		$ 200
Dec. 31	Transfer to profit and loss to close out account		7,900
		$8,100	$8,100

	1953		
Feb. 8	Premium on liability insurance on trucks and salesmen's autos, August 1, 1952, to July 31, 1953	$ 4,500	
Mar. 31	Fire insurance on new building during construction, March 31, 1953, to July 31, 1953	7,500	
Apr. 5	Additional premium on fire insurance (new building), due to increased valuation, April 15, 1953, to July 31, 1953	250	
Apr. 15	Payment by Fidelity Insurance Company, reimbursement for loss, R. Jones, October 25, 1952		$ 900
July 1	Premium on fire insurance policy (building) August 1, 1953, to July 31, 1954, covering new building and increased valuation of old building	1,500	
Aug. 1	Premium on fire insurance policy on stock of goods, period August 1, 1953, to July 31, 1954	1,400	
Aug. 1	Premiums on employees' fidelity bonds, August 1, 1953, to July 31, 1954	3,000	
Dec. 15	Defalcation of P. Smith to be reimbursed by Fidelity Insurance Company in 1954	2,000	
Dec. 31	Transfer to profit and loss to close out account		19,250
		$20,150	$20,150

Note. Premium on liability insurance on trucks and autos, period August 1, 1953, to July 31, 1954, amount $5,400, had not been paid or recorded. (AIA)

Problem 12–3. Outline an audit procedure for the examination of insurance as reflected in the insurance accounts generally carried by a mercantile company. (AIA)

Problem 12–4. The following property control account is shown on the books of the *X* Company:

Balance at December 31, 1953 (land)			$586,000.00
Additions:			
Feb. 28	Transfer from construction work in progress, building completed	$100,000.00	
Feb. 28	Removal of old building to make room for a new structure	15,000.00	
June 30	1952 taxes on real estate (valuations: land, $50,000; buildings, $100,000. Rate, $3.00 per $100)	4,500.00	
July 31	Legal and out-of-pocket expenses re title search of property not acquired	200.00	
Oct. 31	Purchase of two machines, including freight, $78.20, and installation, $100	1,078.20	
Oct. 31	Cost of removing used machines replaced by above purchase	45.00	
Nov. 30	Cost of removing the two machines to third floor to effect more economical operations	71.80	120,895.00
			$706,895.00
Credits:			
Mar. 31	Sale of old building materials		200.00
Balance at December 31, 1954			$706,695.00

Prepare an analysis of the account in good form including such adjusting entries as you consider necessary. (AIA)

Problem 12–5. What audit procedures are required with respect to: (1) additions to property accounts of a manufacturing company during the year under review. The additions to be considered comprise property additions (*a*) constructed by a company using construction work order records, (*b*) acquired by direct purchase from outside vendors, and (*c*) acquired through consolidations, etc. (2) Retirements of property by a manufacturing company during the year under review. State in your answer sources from which you would expect to obtain needed information. (AIA)

Problem 12–6. For what purposes and in what manner does an auditor study depreciation accounts? (AIA)

Problem 12–7. Write a general outline of procedures to be followed in examining a patents account. (AIA)

Problem 12–8. Below will be found a copy of a section of the Equipment Account of the Perfection Printing Company. It has been written up by a clerk known to you to be not only inaccurate but also deficient as to accounting theory and practice.

You are asked to scrutinize the entries for the six-month period prior to June 30. You should: (*a*) prepare adjusting journal entries and make suggestions for whatever other corrections may be required; (*b*) state the corrected balance of the equipment account at June 30, 1954, assuming the balance at January 1 to have been correct; (*c*) organize your solution in an acceptable work sheet.

Notes:

(*a*) Your clients have been engaged in war work and have already taken certain steps toward reconversion, to meet the cost of which they have accumulated a substantial reserve.

(*b*) Entry of February 10: Monotype machine cost $4,000; depreciation accrued to date of sale, $3,000.

(*c*) Entry of March 3: Cost of this motor, $90; depreciation accrued to date of sale, $45; an amount of $15 for which this piece of equipment was sold on March 3 was credited (direct from cash book) to Other Income.

(*d*) Entry of April 2: Purchase will enable the company to print in a new style of type.

(*e*) Entry of May 17: Cost of the shelving was $160 against which depreciation of $40 had been accrued to date of sale. Sold for $15 cash.

(*f*) Entry of June 8: Cost of the old shop lights was $400; depreciation accumulated to date of sale, $220; sold for $65 cash out of which $13 commission was paid.

(*g*) Entry of June 15: According to the engineer's bill, the $1,000 charge covered a survey and preparation of a report on proposed new shop layout occasioned by the discontinuance of war work and return to production of civilian merchandise.

(*h*) Entry of June 30: The amount of $3,600 is an estimate of the loss of profit occasioned by closing during the period covered by the engineering survey above referred to. Corresponding credit was made direct to Profit and Loss account.

PERFECTION PRINTING COMPANY, INC.

Equipment Account

Date			Reference	Debit	Credit
Jan.	1	Balance forward		$738,900	
	25	Kelly press #K-10	VR 12	2,500	
	25	Kelly press #K-10—freight	CB 96	130	
	30	Kelly press #K-10—installation	VR 25	200	
Feb.	10	Sale of monotype machine	CB 98		$1,300
	12	Second-hand, high-speed cutter	VR 30	1,350	
	19	Depreciation on monotype sold Feb. 10	J 75		
	25	Reversal of Feb. 19 entry	J 76		
	27	Betterments—hand feed press #3	VR 39	100	
	27	Betterments—hand feed press #3	PR 67	50	
Mar.	3	Loss on sale of 2-hp motor	J 78	30	
	5	Reversal of March 3 entry	J 78		30
	5	Westinghouse 2½-hp motor	VR 74	115	
	14	Sorter—repairs	CB 105	60	
April	1	Graphite lubricating service	VR 46	85	
	2	New sets of O E type (brass)	VR 46	370	
	9	Cases of black and green ink	VR 47	150	
	15	Sundry equipment purchased at auction	CB 113	900	
	15	Agent's commission on above purchases	CB 114	90	
	15	Agent's expenses on above purchases	PC 49	10	
May	4	Painting 3 old presses	PR 90	12	
	9	Metal shelves for paper stock	VR 52	340	
	17	Sale of lumber from old shelves	CB 130		15
	17	Profit and loss on sale of equipment, loss on sale of old shelves	J 81		105
	30	Wiring for new shop lights	VR 56	160	
	31	Fluorescent fixtures complete with tubes	VR 57	500	
June	8	Sale of old shop lights	CB 134		65
	8	Commission on sale of old lights	CB 135	13	
	15	Engineer's fee (reconversion survey)	CB 141	1,000	
	30	Estimated loss in production during period of reconversion survey	J 84	3,600	
				$753,650	$1,500

(AIA)

Problem 12–9. Your client ships goods in valuable containers. Containers are billed to customers and charged to their accounts at approximately 200% of cost price at the time the product is billed. They are, however, shown separately on the invoice, and allowance of the amount billed is made if they are returned within three months. Describe the purposes of the various steps an auditor should take in connection with the containers and the accounts affected thereby. (AIA)

Problem 12–10. During your audit of the Burney Corporation, which was organized in June 1954, you came across the following account in the general ledger at the date of the audit, December 31, 1954:

Fixed Properties

Date		Item	Debits
June	8	Organization fees paid to the state	$ 1,500
	16	Bond discount	2,400
	16	Land site and old existing building	240,000
	30	Corporate organization costs	3,000
July	2	Title clearance fees	2,800
Aug.	28	Cost of razing old existing building	4,200
Sept.	1	Salaries of Burney Corporation executives	9,700
Dec.	12	Stock bonus to corporate promoters; par value per share, $10; 2,000 shares	20,000
	15	Bond interest, six months	1,500
	15	County real estate tax	2,200
	15	Cost of the new building completed	555,000

In addition, during the course of this audit, the analysis of the foregoing account and of other accounts disclosed the following information:

(*a*) The building acquired June 16 was valued at $40,000.

(*b*) The company paid $4,200 for the demolition of the old existing building, then sold the scrap for $200, and credited the proceeds to miscellaneous income.

(*c*) The company executives did not participate in the construction of the new building.

(*d*) Bonds of a par value of $100,000, life 10 years, were sold to an underwriting syndicate at 97.6.

(*e*) The county real estate tax was for the six months ended December 31, 1954, and was assessed by the county on land.

Prepare adjusting entries to correct the fixed property account. Each journal entry should include an explanation. Also prepare a work sheet in good form including an analysis of the account per books, your adjustments, and the adjusted balance. (AIA)

Problem 12–11. List and give briefly the purpose of all audit procedures which might reasonably be taken by an auditor to determine that all fixed asset retirements have been recorded on the books. (AIA)

Problem 12–12. A manufacturing company whose records you are auditing has \$1,000,000 of buildings and \$3,000,000 of machinery on its books. During the year you are covering in your audit, additions amounted to \$100,000 for buildings and \$500,000 for machinery. All additions were made through construction work orders controlled by a Construction Work in Progress account, which had a balance of \$20,000 at the close of last year and \$55,000 at the close of this year. Some of the additions were purchased, and a number were constructed by the company. You are to state in detail the audit procedure you would follow in verification of the fixed asset additions during the year. You may assume that your firm has made the audit for the prior year. (AIA)

Chapter 13

EXAMINATION OF LIABILITIES

Applicable Audit Techniques. It should be apparent that liabilities and ownership interests in a business are not of the type that lend themselves to verification by physical examination and count. Reliance on other techniques is therefore necessary. Confirmation is frequently useful, particularly if a single or a few large amounts are in question. Reference to original documents is often helpful, and in this connection it may be mentioned that a considerable variety of documents is included. Contracts, royalty agreements, minutes of board of directors' and stockholders' meetings, tax returns, invoices, and others may all be of interest.

Recomputation and retracing bookkeeping procedures of course are useful to some extent in almost every phase of an examination. In the verification of liabilities and net worth balances, however, they are used much less extensively than in the verification of asset accounts. Scanning, on the other hand, is a technique of great usefulness in the examination of liability and net worth data. The propriety of the accounting treatment and of the classification and description of given items is best determined by careful scrutiny of the entries. Dates, periods of time, and peculiar terms of an agreement or contract must be observed carefully. Scanning and examination of appropriate documentary evidence are probably the two techniques of widest application in this phase of the examination. Inquiry, the examination of subsidiary records, and correlation with related information are also useful but tend to assume a minor role.

PURCHASE TRANSACTIONS AND ACCOUNTS PAYABLE

The relationship of purchase transactions to accounts payable is direct and apparent. Most accounts payable arise out of purchase transactions and to some extent the propriety of the purchase indicates the propriety of the liability. For this reason they should be viewed as a single problem both from the standpoint of reviewing the internal control and of preparing and completing a verification program.

The methods of accounting or bookkeeping for accounts payable vary greatly from one concern to another, and this has its effect on the verification procedures applicable to this problem. For example, under some systems a ledger account is maintained for each supplier and the total transactions with that creditor together with the balance owing at any one time can readily be determined. Under other systems, such as the voucher system, there may be no ledger accounts and no summary of all transactions with each customer. The balance owing at one time may consist of several different vouchers filed at different points in the unpaid voucher file because of different dates for payment. Variations of this kind must be taken into consideration in planning the work to be done in as much as some tests are well-nigh impossible under certain systems of accounts payable bookkeeping. These will be indicated as the discussion of specific steps is undertaken.

Purpose of Accounts Payable Verification. In his examination of the accounts payable, an auditor is concerned chiefly with ascertaining whether all liabilities are recorded and whether they are properly described. A company eager to "improve" its apparent financial position could do so either by overstating current assets or by understating current liabilities. Thus an auditor must be alert to any tendency either to omit accounts payable from the statements and accounts or to describe them improperly as noncurrent items if they actually belong in the current liability category.

There is always the possibility of overstatement of accounts payable also, but this is relatively unlikely compared with the possibilities for understatement.

The interrelation of inventory and accounts payable should be fully understood in regard to the general problem of understating liabilities and overstating assets. If goods have been received and included in the inventory as of the year end, but the invoice has not been entered in the purchases book or voucher register by the same date, the current assets have been increased by the cost of the merchandise without a corresponding increase in accounts payable. The profits for the period will likewise be overstated by the same amount. On the other hand, if the invoice has been recorded before the year end but the merchandise was not yet received and therefore was omitted from inventory, the current assets are understated with respect to the current liabilities, and the net income for the year likewise will be less than it should be.

Careful attention must therefore be given to purchase transactions close to the end of the accounting period to determine whether the

inventory and accounts payable entries have been correlated as they should be. A similar problem exists with respect to invoices received for such expenses as utility bills, repair items, and other expenses of that nature. It is not uncommon for invoices for such items to be received some time after the company has received the benefit of the service. Care must therefore be taken to insure that such liabilities for services already received are included within the accounts payable at the balance sheet date.

Essentials of Verification Procedure. To assure himself that all liabilities have been entered and are described appropriately in the accounts and statements, the following steps should be followed by an auditor:

1. Obtain a detailed list of the accounts payable, compare with the subsidiary record, foot, and agree with control account.
2. Foot and balance control account.
   A. Investigate any unusual entries.
3. Confirm balances of the most active accounts.
4. Compare statements received from creditors with detail account balances.
5. Make search for unrecorded liabilities and out-of-period items.
6. Investigate purchase cut-off.
7. Verify purchase transactions for a test period.
   A. Examine documentary evidence (approved invoice, receiving report, purchase order if available) for all entries in purchases book or voucher register.
   B. Foot and cross foot purchases book or voucher register.
   C. Trace postings from purchases record to general ledger.
8. Foot and balance purchases account.
   A. Investigate any unusual entries.
9. Obtain a representation letter with respect to liabilities.

Obtain a Detailed List of Accounts Payable. The balance of the accounts payable account at the verification date may consist of a trial balance of the subsidiary accounts payable ledger, if one is kept, or may be a list of unpaid vouchers or invoices. In either case, it is necessary that the auditor convince himself of the accuracy of the list and of its agreement with the controlling account balance. This is a reasonably simple procedure if a subsidiary ledger is maintained. If the subsidiary record consists of open vouchers or invoices, some difficulty may be experienced.

In examining the file of unpaid vouchers or invoices it is frequently found that they are filed in a chronological order by date of payment. The list of items making up the balance of the Accounts Payable account, however, may be in some other order. This requires that care be taken to insure that not only are all items in the list represented by legitimate invoices but also that all invoices have been listed. This latter requirement may be met by placing a small tick mark on each invoice as it is examined and then, after all items on the list have been accounted for, running through the file for any unmarked invoices not included on the list.

It is also important that original documents be examined. It is not enough that an auditor examine the voucher prepared by the company under examination; he must see the creditor's invoice on which the voucher is based. This is necessary if he is to make certain that the proper amount has been recorded, that the invoice itself is a legitimate purchase for this company, and that the account charged for the expense or purchase is appropriate. It should be accepted by this time that whenever an original document prepared by outsiders is available as evidence in support of a transaction it should be used in preference to any prepared by employees of the company under examination.

It should also be accepted that in reviewing the invoices supporting the list of accounts payable the opportunity thus presented for reviewing the general propriety of the purchases procedure as well as of the propriety of the transactions themselves should be taken. That means that required approvals on the invoices indicating the completion of tests of footings, prices, and extensions, comparison with the purchase order and receiving report, and the like should be reviewed as well.

Foot and Balance Control Account. To avoid understatement of accounts payable by the simple expedient of underfooting the general ledger account, the account must be footed and balanced, and, of course, any unusual entries should be investigated. Credits should come from the purchases record and debits from the cash disbursements book. Any other entries should be traced back to their source, appropriate documents examined, and approval for the transaction noted.

Confirm Balances of Most Active Accounts. There is some difference of opinion among accountants as to the desirability of confirming the balances of accounts payable. This follows not from any doubt as to the validity of the evidence provided by the confirmation technique but rather from the difficulty of applying the procedure on the one hand

and the reliability of other procedures, such as the search for unrecorded liabilities, on the other.

Unless a concern has a subsidiary ledger system for accounts payable, it is extremely difficult to agree the amount confirmed by the creditor with the company's record of the total amount owed to that creditor. Assume, for example, a voucher or unpaid invoice system with the items in the unpaid file in order by date of payment. This means that invoices payable to a certain creditor might be scattered anywhere throughout that file depending on when they are to be paid. To compile the total of the amount owed to the supplier in question, it would be necessary to review every invoice in the file, and then to agree that total with the amount shown on the confirmation. If there is a difference, recourse must be had to the paid voucher file for any paid invoices which might account for the difference. This is a long and tedious task and therefore limits seriously the amount of such confirming that can be undertaken.

Even with this practical objection to the confirmation procedure it is a sound method of verifying accounts payable and should be applied in some small measure if at all practicable.

In selecting accounts to be confirmed it is not always wise to take the largest balances as these are the ones least likely to be understated. A better procedure is to scan the purchases record for the suppliers with whom the greatest amount of business is done, and to request from them the balance which their records show to be receivable from the concern under examination as of the verification date.

Examination of Statements Received from Creditors. If the company receives statements from its creditors, these may be used in lieu of confirmations to prove the balances of accounts payable accounts. There is an advantage in using such statements in that frequently the component parts of the amount owed, invoice by invoice, are indicated on the statement, a fact that makes checking out of the balance much simpler. On the other hand, there is a decided weakness from the verification standpoint in that such creditors' statements must be obtained from the company, and any statements the company did not want the auditor to see could easily be suppressed. Therefore creditors' statements should never be relied on completely, but rather should be used to supplement the confirmation procedure.

It should be apparent that the objections to the confirmation procedure for accounts payable apply to a considerable extent to the use of creditors' statements as well.

Search for Unrecorded Liabilities. If care is taken in its timing and performance, a search for unrecorded liabilities and for out-of-period items can be extremely effective in discovering any attempts to understate accounts payable to trade creditors. It is based on two points which must be fully understood if the usefulness of the test is to be comprehended.

First is the fact that much of the audit work is done a considerable time after the end of the period under examination. For example, an examination of the accounting data for the year ended December 31 could not be completed until the company's accounting department had footed and posted all books of original entry, prepared a trial balance, worked out the adjusting entries, balanced subsidiary ledgers with the control accounts, and in general completed its accounting work for the year. This may take some weeks after the end of the year. In addition, the audit work itself will take an additional period, so it is not unusual for an audit for a year ended December 31 to be completed no earlier than the middle of the following February. This gives an auditor the benefit of a considerable amount of hindsight. He can evaluate conditions as they appeared on December 31 in the light of events subsequent to that date.

The second point is that, to maintain a satisfactory credit rating, a matter vital to most companies, invoices from creditors must be paid, if not within the discount period, at least within thirty days in most cases. Some industries allow as much as sixty days before assessing a penalty, but in most cases thirty days is the limit. This means that, for purchases made before the close of the period under examination, payment is generally required before the auditor completes his work of verification. If invoices are omitted from the accounts payable at December 31 either inadvertently or in order to understate the liabilities on that date, they will very likely be paid before the auditor completes his work. Therefore, if he knows where to search for such items he is very likely to discover them.

In looking for unrecorded items, what to look for is at least as important as where to look. The auditor is interested in any invoice or bill of any kind which should have been regarded as an account payable at the verification date. As he finds such items they should be listed and further investigated as to materiality, effect on other accounts such as inventory or expenses, and as to date of actual entry. The controlling information may be the invoice date and terms, the date of an attached or related receiving report, or the period covered by the bill if it is not

a merchandise purchase. To all of these, an auditor must give attention before passing any specific invoice. Thus a purchase invoice with terms of F.O.B. shipping point dated before the year end, an invoice dated F.O.B. destination with a receiving report indicating that the goods were received before the balance sheet date, and a utility bill for a portion of the year under examination, all require investigation. When questionable invoices are found, they should be carefully traced into the list of accounts payable items to make sure that they have not already been included before adjustment is recommended. If not included in the list of payables at the year end, an adjustment is required.

In searching for such unrecorded liabilities, it is important that attention be given to the timing of the work as well as to all points at which evidence might be uncovered. The search should be made as late in the audit work as possible in order that an adequate period between the balance sheet date and the search may have expired. The longer this period, the more chance there is that any unrecorded items will have been paid or entered or both. The following should be reviewed carefully:

1. Unpaid invoice file at date of search.
   It is possible that invoices out for approval or for investigation were inadvertently omitted from the list and will have been returned for payment. These may well appear at this later date in the unpaid file awaiting payment.
2. Paid invoice or voucher file.
   If the invoice has since been paid, it most likely will be filed along with other invoices either in a numerical file or under the name of the creditor. In either case the paid voucher file must be searched carefully for items paid since the balance sheet date which were liabilities on that date but which were omitted from the list of accounts payable.
3. Purchases book for the following month.
   Any major purchases recorded in the month following the verification date should be investigated to ascertain whether they were actually made before the audit date. Not all items should be investigated, of course, but those of material amount should be examined.
4. Cash disbursements record for the following month.
   In the same manner any large cash disbursements may represent the liquidation of liabilities existent but not of record on the balance sheet date. These should be investigated sufficiently to

assure the auditor either that they were included in the balance or should not have been so included.

5. Open purchase orders.

   Inquiry should be made as to any purchase orders dated prior to the verification date and still open. These may have been filled but, through error, never recorded properly. Correspondence with the supplier should be requested for examination, and, if necessary,

Clement Company
Review of Purchase Invoices
12/24/54 through 1/7/55

Supplier	Description	Amount	Invoice Date
Zappan Foundries	Raw materials	71480	12/20/54
Disinger Supply Co	Parts	21565	12/20/54
Moran Metal Works	Parts	31200	12/19/54
Hageman and Co	Raw materials	48760	12/25/54
Link Products	Packing supplies	22700	12/23/54
Turner Box Co	Packing supplies	41650	12/27/54
Lammen, Inc	Raw materials	18212	12/23/54
Disinger Supply Co	Parts	11560	12/26/54
The Leavitt Company	Raw materials	84650	12/29/54
The Boe Valve Company	Parts	21145	12/31/54
Zappan Foundries	Raw materials	17310	1/3/55
Moore + Moore	Raw materials	42481	12/31/54
Hageman and Co	Raw materials	71265	12/28/54
Capener Electric Co	Parts	21008	1/4/55
Lammen, Inc	Raw materials	31750	12/29/54
Hafeling Mfg Co	Parts	81240	12/28/54
Sanders Products, Inc.	Tools + dies	17680	1/3/55
Kirkham Rubber Co	Raw materials	16288	12/27/54
The Lee Company	Raw materials	23140	12/30/54
Stevens Parts Supply	Parts	31150	1/3/55
Stan Hall + Company	Fittings	41222	12/31/54
Capener Electric Co	Parts	10912	1/4/55
Link Products	Parts	21750	1/3/55
Hafeling Mfg Co	Parts	46540	12/31/54
The Boe Valve Company	Parts	51220	1/3/55
Sanders Products, Inc	Tools + dies	31687	1/4/55
Miller Metal Products	Parts	20915	12/30/54
Link Products	Parts	17680	1/4/55
Hageman and Co	Raw materials	21245	1/6/55
Moran Metal Works	Parts	71698	1/5/55
Local Power Company	Utilities bill	14237	1/4/55

All invoices entered 12/24/54 through 1/7/55 in excess of $100.00 examined for unrecorded liabilities and out-of-period items as above.
Physical Inventory taken 12/31/54 - all goods on hand counted and included in inventory.
See audit program page 4 for other work on unrecorded liabilities.

Illustration 22. Work sheet for review of

inquiry should be made of the receiving department and examination of receiving reports undertaken.

Purchase Cut-Off. As discussed in connection with the verification of inventory, purchase transactions for a few days on each side of the inventory date must be carefully reviewed with respect to time of title passing, inclusion in inventory, and date of entry in purchases book.

RSM 2-7-55

FOB Terms	Entered in Invoice Register	Date of Receiving Report	Adjustments Required at 12/31/54 — Purchases Dr	Purchases Cr.	Inventory Increase	Inventory Decrease
Dest	12/24/54	12/23/54				
Dest	12/24/54	12/23/54				
Dest.	12/24/54	12/24/54				
Sh pt	12/27/54	12/24/54				
Dest	12/28/54	12/27/54				
Sh pt	12/28/54	12/27/54				
Sh pt	12/29/54	12/30/54				
Sh pt	12/29/54	12/29/54				
Dest	12/30/54	12/29/54				
Sh pt	12/30/54	12/29/54				
Dest	12/30/54	12/29/54				
Sh. pt.	12/31/54	1/3/55			42481	
Dest	12/31/54	1/3/55		71265		
Dest	12/31/54	12/31/54				
Sh pt.	12/31/54	1/3/55			31750	
Dest	1/3/55	12/31/54	81240			
Sh pt	1/3/55	1/3/55				
Sh pt.	1/3/55	1/3/55	16288		16288	
Dest	1/4/55	12/31/54	23140			
Dest	1/4/55	1/3/55				
Dest	1/4/55	1/4/55				
Dest	1/4/55	1/4/55				
Sh pt.	1/5/55	1/3/55				
Sh pt.	1/5/55	1/4/55	46540		46540	
Dest.	1/5/55	1/4/55				
Sh pt.	1/6/55	1/5/55				
Dest	1/6/55	1/5/55				
Sh pt	1/7/55	1/7/55				
Sh pt	1/7/55	1/6/55				
Dest.	1/7/55	1/6/55				
Dest	1/7/55	1/5/55				
			167208	71265	137059	-0-
			71265		-0-	
			95943		137059	

purchase invoices (purchases cut-off).

This is important from the standpoint of accounts payable as well as from that of inventory. If the inventory is taken at the close of the fiscal period under examination, one test for both purposes may be sufficient. If the inventory is taken at some previous date, it may be necessary to repeat the test at the end of the examination period to discover any errors in recording purchase transactions at that time.

A work sheet indicating how the information for such a test may be organized is presented in Illustration 22.

Test of Purchase Transactions. The examination of documents supporting entries in the purchases record or voucher register, footing and cross footing of that record, and tracing posting to the general ledger require little explanation. Before commencing such work the internal control should be carefully reviewed both to discover any apparent weakness and in order that during the examination of the documents attention can be given to required approvals.

Most companies provide for the "matching" of related invoices, receiving reports, and purchase orders. In addition, the prices, extensions, and footings of every invoice are generally proved before the invoice is approved for payment. The practice of the specific company under examination should be carefully ascertained and then kept in mind throughout this part of the verification work. Any failure on the part of company employees to follow instructions in this respect should be noted and reported.

Once transactions for a test period have been verified and traced into the ledger, the purchases account has been given at least a test verification. It should then be footed and the balance proved. Any unusual entries, that is, not coming from the columnar purchases record, should be investigated and any credits to the account likewise should be traced back to original transactions for propriety.

As mentioned previously, the balances of the Sales and Purchases accounts are generally the two largest in the ledger. Anyone desiring to "bury" a transaction or an amount for any reason at all might charge or credit it to one of these two accounts. It is usually unnecessary and impracticable to review every purchase or sales transaction. If, however, the entries in the purchase record are carefully examined for a test month or more, and if it is then found that all transactions recorded in the Purchases account come from that record, one is reasonably secure in assuming that only legitimate purchase transactions have been recorded in the account. If, on the other hand, there are debits and credits from other sources such as general journal entries, they must

Williams & Roberts, C.P.A.'s
Bankers Trust Building
Chicago, Illinois

Gentlemen:

In connection with your examination of the financial statements and accounts of Grand Manufacturing Company as of the close of business December 31, 1954, and to the best of my knowledge and belief, provision has been made on the books as at that date for all direct liabilities of the company.

The company was not liable at that date as an endorser or guarantor on any accommodation paper, contract, or agreement of any kind, and had not pledged any of its assets except as follows:

The company then had no outstanding contracts of a speculative nature for materials or other items, had no damage or law suits pending against it, and was not otherwise contingently liable on account of discounted notes, acceptances, or other forms of obligation except as follows:

The company has no unfilled contracts for the purchase of materials or sales of products to be liquidated at specific prices differing from current market prices except as follows:

Very truly yours

Illustration 23. Liability representation letter.

be investigated for propriety as well as to determine if the nature of the transactions justify entry in the purchases account.

Accounts Payable Representation Letter. Serious consideration of the verification problem involved in accounts payable should reveal that an auditor can never be as certain of the accuracy of the balance of Accounts Payable as he can be of Cash, Investments, and certain other accounts. One of the chief reasons for his doubt on this important account is the possibility that the management, inadvertently or intentionally, may omit liabilities from the financial statements and accounts. For this reason it is customary for an auditor to request management to supply him with a statement to the effect that all known liabilities have been recorded and that no transactions have been omitted from the books of account.

This representation in no way relieves the auditor of responsibility for applying adequate verification procedures. It is, however, evidence that he has taken the precaution of asking management important questions which should be asked and that management gave a considered answer to the questions. A representation of this kind also has the advantage of serving as a reminder to management and is more effective in this respect than would be an oral inquiry.

NOTES PAYABLE

An auditor must ascertain whether the liability for notes payable as stated in the financial statements and accounts is correct, and further, whether there are any unrecorded notes payable. To do this it is generally necessary to:

1. Prepare a list of all notes payable, foot, and agree the total with the balance of the controlling account.
2. Confirm the details of notes payable with the holders thereof.
3. Compute accrued interest and tie in with the interest expense for the period.
4. Trace the proceeds of notes issued to determine that the company received the benefit thereof.
5. Examine canceled checks or other evidence for payments made during the period.

There is nothing particularly new about any of the procedures suggested here for notes payable; most of them have been applied to other

data and therefore have been explained. It should be observed by reference to Illustration 24 that all this information can be included in one work sheet arrangement, and that if organized properly it provides a verification of all note transactions during the period under examination.

The importance of agreeing the interest expense with accrued interest and with the note transactions is particularly important in that a failure to account for all interest expense recorded by the company may indicate the existence of unrecorded notes on which interest has been paid.

The possible existence of unrecorded notes payable is a matter on which the auditor can never be completely satisfied and yet one on which the procedures outlined in this section, supplemented by the confirmation of bank balances and a search for unrecorded liabilities, should give him reasonable assurance. In confirming bank balances it is common practice to send confirmations to all banks with which the company is known to have done any business at all during the period, and to request the bank to give, in addition to the balances of all accounts, full information on notes, endorsements, and contingent liabilities. (See bank confirmation, Illustration 10.) Unless an account is established at the time of the loan, it is generally somewhat difficult to borrow from a bank with which a company has never had any previous business. Thus this bank confirmation procedure goes a long way toward discovering any unrecorded notes payable to banks.

Notes payable to trade creditors generally follow from a purchase and accounts payable transaction, so there is little opportunity or likelihood that such transactions will go unrecorded. Therefore, unless special circumstances indicate a need, there is little reason for special attention to this possibility.

The search for unrecorded liabilities should be extended by the one applying it to a consideration of payments of any liabilities and in this way may serve to discover liabilities paid since the balance sheet date but not of record on that date.

OTHER LIABILITIES

A variety of other liabilities may be found in existence for any company. Some of them are the type that an auditor expects to find in almost any case, and others appear only in certain instances. An auditor familiar with business soon comes to know which liabilities can be expected in most cases and what indications are that more unusual ones exist. For example, he should realize that any company is likely to have accrued wages and accrued social security taxes, and that a company

The Stevens Company
Notes Payable
12/31/54

Payee	Date of Note	Term	Date Due	Interest Rate	Balance 12/31/53
First National Bank	10/31/53	6 mos.	4/30/54	6%	300000 ✓
Allied Machinery Company	12/1/53	2 yrs	12/1/55	5%	180000 ✓
First National Bank	4/30/54	6 mos	10/30/54	6%	
Jonas P. Stevens	6/30/54		Demand	4%	
					480000

Illustration 24. Work sheet

with salesmen working on a commission basis is very likely to have accrued salesmen's commissions. No rules can be given to enable an auditor to know as a matter of course all liabilities for any given company; it is more a matter of knowledge of business operations coupled with an alertness to the facts of the situation.

RAM
2-7-55

Notes Payable			Interest on Notes Payable				
Notes Issued	Payments Made	Balance 12/31/54	Prepaid 12/31/53	Accrued 12/31/53	Expense in 1954	Paid in 1954	Accrued 12/31/54
	4/30 300000 ✻	-0-	6000 ✓		6000 n		-0-
		180000		750 ✓	9000 n	11/30 9000 ✻	750 n
4/30 300000	10/30 300000 ✻	-0-			9000 n	4/30 9000 ✻	-0-
600000		600000			12000 n		12000 n
900000	600000	780000	6000	750	36000	18000	12750
		T.B.			T.B.		T.B.

✓ From our 12/31/53 work papers

✻ Voucher check examined; traced to check register

c See confirmation attached

n Calculations verified

(21)

for notes payable.

Accrued Liabilities. If no accrual has been recorded for such common items as accrued wages and salaries, taxes, and commissions, the auditor should inquire as to the reason for their omission and should satisfy himself that no significant error has been made in not recording them. If they have been recorded, he should make such tests as seem

appropriate and in every case where it is at all possible should relate the amount of the accrual to the expense for the year.

For accrued wages it is generally possible to work out at least a rough test by taking a proportionate amount of the first payroll after the end of the year. If, for example, the regular pay period was for two weeks consisting of five work days each and the last day of the year fell four days after the end of the last previous pay period, the accrued wages should be approximately four-tenths of the next payroll. If the company has computed the actual accrual from the payroll records, such calculations can be reviewed briefly and then tested roughly as described. If no accrual has been made at all, an estimate based on such a computation is generally accurate enough for all practical purposes.

A review of the minutes of the board of directors' meetings will indicate the declaration of dividends and the dates on which they become a liability of the company. Recomputation based on the amount of outstanding stock is generally sufficient to test the liability as recorded by the company.

Accrued commissions can sometimes be verified by confirmation, but this is seldom practical as salesmen and employees rarely have accurate records of the amounts owed to them as of a given date unless they can first check on the status of various partially completed transactions. However, the company must have some sort of salesmen's commission record from which it normally computes commission payments. After study of the commission agreement an auditor can generally work out from this record what the commissions earned but unpaid at the verification date should be.

Some accrued taxes may be related to a variable such as income or wages and therefore must be computed in view of what the base figure is and the provisions of the applicable law. For example, the federal old age benefits tax is based upon wages paid to individuals up to a fixed amount in any one year. The amount accrued at the verification date must be computed based on wages paid and the tax rate in effect. Federal income taxes are a far more difficult problem, yet are of the same basic nature. The applicable tax rate must be applied to the taxable income. An auditor must consider it part of his duties to be acquainted with the provisions of applicable tax laws so that he can recompute tax accruals and judge the company's provision accordingly.

Other taxes are not computed by the taxpayer but are assessed by the taxing authority. Real and personal property taxes are examples of this type. If a tax bill has been received by the company, the appropriate accrual can readily be determined by reference to the tax bill.

Frequently, however, the tax bill for the current year has not yet arrived at the time of the audit and the auditor must either calculate the accrual or evaluate the company's provision on some other basis. If the current year's tax bill is not available, the bill for the preceding year probably provides as sound a basis as can be found for estimating what the current year's tax will be. Hence, it is customary to call for the tax bill for the preceding year, and, after taking into consideration any important additions to or reductions from the tax base, to judge the accrual required. For example, if the real property tax bill for 1953 was $4,500 and no important changes in the fixed asset accounts had taken place during the year, it is a fair assumption that the tax bill for 1954 will run about the same or perhaps slightly higher.

Incidentally, the tax bill for the preceding year should also be examined to discover whether it has been stamped as paid by the authorized collector and the company thereby relieved of liability for it as well as to discover whether the company is listed on the tax rolls as owner of the property it claims.

In some localities it is accepted practice to render tax bills considerably in excess of the amount finally settled between the taxpayer and the taxing authority. In such cases the tax bill itself is very little indication of what the liability actually is. Correspondence with the company's attorneys or tax counsel may give a more accurate indication of what the accrual should be.

Long-Term Debt. Long-term debt is seldom a difficult verification problem. The possibilities of concealment are remote, and, once the auditor has knowledge of the existence of the debt, it is a comparatively easy matter to refer to copies of the debt agreement for such details as are necessary to prove the company's accounting.

In every case, terms of the mortgage agreement or bond indenture should be carefully studied to ascertain its accounting provisions and requirements. If these are of interest to those who read the financial statements, it is important that they be disclosed fully by footnote or otherwise. Where a sinking fund or a sinking fund reserve is required, the auditor should assure himself that the provision is being made as required or, if it is not, he should so state in his report.

The confirmation procedure should be used to verify the amounts of every material obligation possible; it is particularly adapted to proving the amount of a mortgage payable and of a bond issue handled by a trustee, transfer agent, or registrar.

A bond issue presents a somewhat different problem from a mortgage because of the possibility of unissued bonds which if issued become a liability. If the unissued bonds are in the hands of the company, a count is required to ascertain that all unissued bonds are on hand and accounted for. If a bank or trust company serves as transfer agent and issuing agent for the bonds, a confirmation may suffice not only for the existence of unissued bonds but also for all pertinent details of the obligation. Any treasury bonds, like unissued bonds, should be verified by examination and count.

In every case accrued interest should be computed and tied in with the interest expense for the period under examination. Interest payments not related to any liabilities recorded in the accounts are occasionally discovered in this way and always require careful investigation.

Any increase in a long-term liability of course implies that cash was received. Such transactions should be verified further by tracing the increase in cash into appropriate accounts.

Contingent Liabilities. Ordinary alertness to the possibilities of contingent liabilities in each business situation under examination is the first step toward discovering any contingent liabilities requiring disclosure in the financial statements. Requesting information with respect to guarantees and endorsements when bank balances are confirmed and when a liability certificate is obtained from the company's officers are additional steps. It is also a regular practice to correspond with the company's attorneys and inquire as to the existence of any law suits or matters of that type known to them. If an auditor has taken all these steps he should discover all significant contingent liabilities unless there is a deliberate effort by management to conceal them. At any rate he has discharged his responsibility for their discovery.

PROBLEMS—CHAPTER 13

Problem 13–1. Briefly outline at least twelve steps that should be taken in the examination of the current liabilities of a mercantile or manufacturing concern. (AIA)

Problem 13–2. Indicate the steps necessary to establish that the amount of accounts payable-trade, reflected in the balance sheet, is correct in so far as it relates to merchandise included in the balance sheet on the basis of a physical inventory taken as at the date of the balance sheet. (AIA)

Problem 13–3. Write an audit program covering current liabilities of a medium-sized manufacturing concern.

Problem 13–4. When profit-sharing coupons, trading stamps, etc., are issued by a company to its customers along with the sale of merchandise, a liability to meet the cost of redeeming the obligations may be created. What should the auditor do to satisfy himself that the provision carried on the books of the concern under audit is adequate? (AIA)

Problem 13–5. Your client keeps accounts on an accrual basis and maintains an invoice register in which invoices are entered when they become liabilities. What procedure would you follow in examining this register and supporting records for a selected month in the year under review? (AIA)

Problem 13–6. Outline for use in a balance sheet audit of a mercantile organization a program for the verification of the balance of Trade Accounts Payable when a subsidiary ledger is maintained for such accounts with a control in the general ledger. (AIA)

Problem 13–7. The Bickers Company, for twenty years manufacturers of "Washwell" washing machines, sells its product under a five-year guarantee against defective production. At December 31, 1954, its balance sheet included among its current liabilities the item, "Reserve for Product Guarantees: $84,325." This account has been credited with $5 for every machine sold and debited with amounts paid dealers who have serviced machines pursuant to the terms of the guarantee, and with other expenditures incurred in accordance with terms of the guarantee. The retail price of the machine during the last five years has ranged from $150 to $250, but the amount credited to the guarantee reserve has been on the same basis during this period. The price to dealers allows them a margin of 40% of the retail price, out of which they are to pay all installation costs and provide all labor required to comply with the terms of the guarantee. Parts and

materials used in carrying out guarantee terms are charged to Bickers at cost to the dealer. If it is necessary to return the machine to the factory, the Bickers Company pays transportation and all servicing costs. Such costs are accumulated on a blanket work order for each month. The company obtains, from each dealer claiming reimbursement for parts used, a detail list of parts, the customers' names, the serial number of the machines, and a certification as to the work having been done. This is approved by the company's service manager.

Assuming that this is your first audit of the Bickers Company, prepare an audit program for the verification of the "Reserve for Product Guarantees."
(AIA)

Problem 13–8. (*a*) In auditing practice, confirmation of accounts payable is less common than confirmation of accounts receivable. Give reasons why this is so. (*b*) Prepare a confirmation request for notes payable.
(AIA)

Problem 13–9. Describe ten steps an auditor should take to satisfy himself that all his client's liabilities, either actual or contingent, as of the date of the balance sheet under examination are reflected in his accounts or otherwise disclosed. (AIA)

Problem 13–10. The company whose records you are examining makes no entry for vendors' invoices received. They are reviewed by a member of the accounting department and if correct are approved for payment. Upon payment they are recorded in the cash disbursements book, charging the appropriate expense or asset account. At the end of each month a list of unpaid invoices is prepared and recorded by adjusting entry. What steps would you take to assure yourself that the amount of accounts payable as shown by the general ledger at the balance sheet date was correct?

Problem 13–11. Why is it important that an auditor analyze the interest expense account in connection with his examination of liabilities?

Problem 13–12. Liability accounts may be directly related to expense accounts much as asset accounts are related to specific expense accounts. List several liability-expense account combinations, and describe briefly the examination procedure you would follow in your verification of them.

Problem 13–13. The balance sheet of a company as at December 31, 1954, contains one item of long-term liabilities described as follows: "Bonds Payable, due October 1, 1973: $92,000." The relative account in the general ledger shows the following:

BONDS PAYABLE—DUE OCTOBER 1, 1973

4/1/54	Cash	$ 9,400
10/1/54	Cash	10,600
10/1/53	Cash	112,000

What should the auditor's procedure be as to: (*a*) confirmations; (*b*) books; (*c*) statements. (AIA)

Problem 13–14. In making an audit of a corporation that has a bond issue outstanding, the trust indenture is reviewed, and a confirmation as to the issue is obtained from the trustee. List eight matters of importance to the auditor that might be found either in the indenture or in the confirmation obtained from the trustee. Explain briefly the auditor's interest in each item. (AIA)

Problem 13–15. In connection with various steps, other than those concerned directly with notes and mortgages payable in the usual annual audit, the auditor's verification work assists him in determining that all notes and mortgages payable are properly recorded on the books of his client. List eight of these procedures, stating the manner in which each procedure aids in determining that notes and mortgages payable are correctly recorded. (AIA)

Problem 13–16. For each of the following types of business enterprise, list one or more liabilities peculiar to that kind of business. Indicate also the records you would call for or the procedures you would use in verification of such liabilities.

1. A used car dealer.
2. A book publishing company.
3. A manufacturer of the patented syrup for a line of nationally known beverages.
4. A chain of moving-picture theaters.
5. A manufacturer of patented products made under licensing agreements.

Problem 13–17. List several contingent liabilities, and state how you would determine the existence or nonexistence of each in an audit examination.

Chapter 14

NET WORTH ACCOUNTS AND TRANSACTIONS AND VERIFICATION OF INCOME AND EXPENSE ACCOUNTS

Net worth transactions present an entirely different problem of verification from that found in connection with sales or receivables, for example. In one case there is a small number of relatively important transactions; in the other there is a great number of relatively small transactions. Also, there is generally more opportunity for questionable or improper accounting in the analysis and recording of net worth transactions.

These facts govern the verification procedures to be applied. Instead of tests applied to samples of the total transactions for the year, it is customary to give each transaction a certain amount of individual attention to ascertain its propriety and appropriate entry. This review of individual transactions attempts to obtain satisfactory evidence that:

1. The transaction is authorized and in accordance with the applicable regulations of the enterprise or controlling agencies.
2. The transaction is entered in accordance with generally accepted accounting practice.
3. Any cash or other proceeds have been received by the company and recorded properly.

Applicable Verification Techniques. In the examination of net worth accounts and nominal accounts alike, the technique of first importance is likely to be that of scanning. This follows from the fact that errors in transaction analysis and entry are so easily made in this area of accounting. Utilizing his knowledge of accounting, business practices, and the specific company under examination, the auditor carefully scrutinizes these accounts for any apparent improprieties. When he discovers an item or an entry that he has cause to question, he must employ such other techniques as inquiry, examination of documentary evidence,

or even confirmation. His approach, however, is most often through scanning.

To a considerable extent income and expense accounts are verified in connection with related asset or liability accounts. In such cases the techniques applicable to the related asset and liability accounts are also effective in verification of the nominal accounts. For nominal accounts not directly related to real accounts, the techniques of most usefulness are likely to be scanning, examination of documentary evidence, and recomputation.

Authorization of Net Worth Transactions. In preparation for his review and verification of net worth transactions, the auditor must obtain and study carefully all documents and papers that may contain information pertinent to this subject. Thus in a corporation he must obtain a copy of the corporate charter, the by-laws, and minutes of the meetings of the board of directors and of the shareholders. These should be read carefully with the intention of discovering any provisions of importance from the standpoint of accounting. Pertinent provisions should be excerpted and included in the audit work papers for later reference. These provisions must then be kept in mind in studying the entries recorded in the various capital and surplus accounts.

Assume, for example, that in reading the by-laws it was discovered that earned surplus could be reserved or restricted only on action by the board of directors. Any surplus reservations indicated in the accounts then should be approved by the board of directors in one of their meetings and the existence of such approval should be investigated by an auditor. If approval is not found, the failure to follow the corporate by-laws should be pointed out. Again it might be found in reading the minutes of the board of directors' meetings that a number of shares of unissued or treasury stock had been earmarked for employees in a program to give the employees a more direct interest in the company. Investigation must then be made to determine whether the stock is actually being held and issued only in accordance with the purposes as established by the board of directors.

If the concern under examination is a partnership rather than a corporation, attention must be given to the partnership agreement instead of the corporate charter, but the same care must be taken to insure that all provisions of the contract are met.

To provide a basis for reviewing the net worth transactions, it is well to prepare a detailed account analysis of each account in the net worth section. Then each entry in the account can be subjected to the search-

ing review required. In studying entries in these accounts, reference should be made to documents supporting the original transactions and to the excerpts of pertinent accounting provisions of the charter, by-laws, and minutes. The authority for entering into the transaction should be given consideration as well as its propriety from the standpoint of the purpose and intent of the corporate organization.

The provisions of state business corporation acts permit considerable variation not only in the transactions into which corporations can enter but also in respect to the way such transactions should be recorded. An auditor must make certain, first of all, that no provision of the corporation act to which the company is subject has been violated. This may require obtaining a copy of the act and studying it, or may be done in consultation with the company's attorney. Then the auditor must review the manner of recording each transaction with the requirements of good accounting in mind. Does the entry as made adequately reflect the facts of the actual transaction? Is it in accordance with the generally accepted practice in that particular industry?

As has been pointed out before, an auditor must be a qualified accountant. He is expected to know what generally accepted practice is and in the face of a new situation is expected to prepare himself by study and research for whatever decisions he may be required to make. Thus in facing an examination of a company with which he has had no previous experience, he must analyze its peculiarities and refer to accepted authorities on any special problems. Throughout his work he is expected to be alert to any evidence that the accounting is not satisfactory; this he can do only if he himself is aware of the requirements of good accounting.

In reviewing the entries in the net worth accounts and the transactions that support them, he should also watch for situations or conditions that will require additional explanatory comment in the financial statements. Failure to disclose all pertinent facts is an error as serious as any other, and should be carefully guarded against. Thus, if he discovers that the treasury stock held by the company can be issued only under a given set of conditions, it may be necessary to indicate this fact as a footnote to the balance sheet and to explain the meaning and significance of the conditions in question.

Balances of Net Worth Accounts. If the opening balances are reliable and if all transactions for the current period have been carefully verified as to propriety, authorization, and entry, the resulting ending balances of surplus and reserve accounts have been automatically verified

and no special attention need be given them beyond that already described. Capital stock accounts, including treasury stock, may, however, require some additional work.

The balance of any capital stock account should be supported by a stockholders' ledger showing the number of shares held by each stockholder and a stock certificate stub book which indicates to whom certificates have been issued and which certificates have been reacquired by the company. Both these records should be examined in support of the balance of the capital stock accounts. The shareholders' ledger should be totaled and reconciled to the total shares shown as outstanding. A review should also be made of the open stubs in the stock certificate stub book to determine whether all certificates issued have been entered in the shareholders' ledger and in the controlling account.

Some attention must be given to unissued certificates to insure that all are present or can be accounted for. A missing certificate is a serious matter as it may be filled in for any number of shares and validating signatures forged. In the hands of an innocent third party it may constitute a strong claim against the company. Hence the explanations offered for missing certificates should be thoroughly investigated before they are accepted.

The balance of any treasury stock accounts should be supported by the reacquired certificates. These should be counted simultaneously with cash and other securities as they may be used improperly to secure funds in the same way as may other securities. Dividends on treasury stock do not, of course, constitute income, and, if they are so recorded, adjustment is required. An auditor should also make certain that any dividends received on treasury stock have been deposited to the credit of the company.

In a first audit, additional attention must be given to the net worth accounts just as it is given to the fixed asset accounts. In order that the opening balance for the year under examination may be relied on, it is necessary to review all transactions recorded in the accounts from the inception of the corporation. This may be restricted to a review of the more important entries but as there generally are relatively few transactions, all of which may be material, it is well to give attention to all entries. Again, recourse should be had to documentary evidence of the authority and propriety of the transaction and to its entry. Any proceeds should be traced into bank deposits.

Many corporations save themselves the task of maintaining capital stock records and of handling capital stock transactions by engaging a fiduciary institution to serve as registrar and transfer agent. In such

cases it is considered sufficient verification if a confirmation of all pertinent facts is obtained from the fiduciary.

Dividend Verification. As with any other net worth transaction, the authority for a dividend payment or declaration must be examined. Reference to the board of directors' minutes should be made to discover not only the approval but also the rate or amount to be paid. Ascertaining the propriety of the dividend is a matter of considering not only the status of the company's earned surplus account but also the terms of any bond indentures or other loan agreements that may place a limitation on dividend payments. This can usually be undertaken only after all other accounts have been verified and decisions have been reached as to the necessity for adjustments.

Based on the directors' resolution and the number of shares of stock outstanding, the total amount of the dividend should be tested by recomputation.

Once a dividend has been declared, it becomes a liability of the company and must be either paid or shown in the balance sheet as a liability. To satisfy himself that the liability for dividends declared during the period has been discharged, an auditor should:

1. Foot dividend lists and compare with total dividend authorized.
2. Trace names and shares shown in the dividend lists back to the shareholders' ledger.
3. Examine canceled dividend checks for date, amount, signature, perforations, and endorsements, and compare them with the dividend lists.
4. Reconcile the dividend bank account.

VERIFICATION OF INCOME AND EXPENSE ACCOUNTS

Throughout this textbook, the close interrelationship of income and expense accounts with balance sheet accounts has been emphasized. In the verification of accounts receivable, for example, sales transactions were also given attention. If done properly, this serves to test the balance of the sales account. Similarly, in the verification of accounts payable, attention was given to purchases. Fixed assets cannot be verified adequately without examination of related repair and maintenance accounts, and depreciation expense should be investigated at the same time as accrued depreciation is analyzed. These are but some of the examples which can be cited.

Thus it is apparent that by the time the balance sheet accounts have been given all the attention they require, a considerable amount of work has also been done on the income and expense accounts. Indeed, if one were to list the income and expense accounts that have been completely or partially verified in connection with the verification of balance sheet accounts it would be found that a large share of the most important nominal accounts had been subjected to audit. In addition to this work, further examination and review of the amounts charged or credited to profit and loss statement accounts is required. For purposes of explanation of the nature of this work these accounts may be divided into three main types which receive attention as follows:

1. Complete verification of the ending balance.
2. Complete verification of the entries for a test period.
3. Comparative review and scrutiny.

Complete Verification. The accounts which are verified completely may be divided into two groups: (1) those such as depreciation and bad debts which are verified in connection with some balance sheet account. This group also includes Interest Expense and Interest Income, Insurance Expense, Dividends Received, and similar accounts. (2) Accounts not related to any specific balance sheet account. In this group are such accounts as Officers' Salaries, which is generally verified completely and agreed with authorized salaries as shown in the board of directors' minutes, any miscellaneous income or expense accounts of material amount, Salesmen's Commissions, employee bonus accounts, and any other accounts which the auditor feels pose a special problem. This is no fixed list but may vary with the engagement and the auditor's evaluation of the situation.

It should be clear that "complete" verification does not mean that without exception every entry must be verified. There are many entries in most expense accounts too small to warrant lengthy consideration. Complete verification implies that some attention is given to the entries in every month and that at least all major items are verified. It stands to reason that immaterial charges and credits may be passed if the larger ones are satisfactorily supported.

Verification for a Test Period. Sales and Purchases are examples of accounts commonly verified for a test period. The program suggested for the verification of sales and accounts receivable provided that the entries in the sales record for at least one month be compared with

copies of duplicate sales invoices and the posting of that record into the general ledger traced. The sales account was then to be footed and any unusual entries, i.e., those not coming from the sales record, investigated. This provides for complete verification of the entries in the sales account for the test month, or months if more than one are selected.

The same verification is made of entries in the purchases account by examining invoices supporting entries in the purchases book or voucher register and tracing the postings from that book back to the ledger.

In addition, the entries in key expense accounts may be verified by reference to the supporting invoices or other documents for a test month or months. This has the advantage of revealing to the auditor just what is charged to that specific account so that he can determine whether the account title is accurate and whether the items have been handled correctly under the company's cost system. In addition, the care with which items are assigned to expense accounts is tested just as accurately as though a great deal more work were done in tracing postings from the books of original entry to the ledger.

Comparative Review and Scrutiny. In addition to the analysis type of verification applied to expense accounts, an experienced and alert auditor can accomplish a great deal solely by reviewing the amounts charged to certain accounts. By review is meant a searching scrutiny of the accounts for items which because of their size, source of entry, or for any other reason appear unusual.

The basis for review should be a comparative trial balance of the expense account balances on as detailed a basis as possible. Many companies have controlling accounts for expenses in the general ledger supported by detailed breakdowns of the control accounts in work sheets or subsidiary ledgers. In reviewing the operating accounts an auditor should work with the smallest subdivisions available so that odd or unusual items are more likely to stand out. For example, an unexplained debit of $500 to a Selling Expense control account would perhaps be so immaterial in respect to the total balance as not to make that account seem out of line this year as compared with last year. That same amount in an account for Miscellaneous Selling Expenses may appear a great deal more significant and call for investigation.

The comparative trial balance is helpful in indicating the extent to which one year differs from another. The amounts for the current year should be scrutinized in view of the amounts for the same account the previous year or years if that information is available. Any large increase or other variation from past experience calls for investigation.

Investigation may take the form of inquiry as to the reasons for the change directed at the company employees or officers, or it may take the form of a partial analysis of the entries in that account. If it were discovered, for example, that the Packing and Shipping account balance had increased considerably over what it was the preceding year, an auditor might well begin his investigation by inquiring of the company controller or chief accountant as to the reason for the increase. Assume further that he was told that an increase in overseas sales following an expansion of their foreign sales force necessitated more expensive packing and shipping arrangements. If he remembered from his work on accounts receivable that there were a good many foreign accounts, some of which had confirmed the balances shown in the customers' ledger, he might accept the explanation at face value. If he had no such corroborating evidence he might select one month and refer to the invoices supporting the charges to Packing and Shipping for that period. If he found that the increased expense for that month did actually result from the cost of overseas shipments, he could well accept the explanation received previously.

If the subsidiary expense ledger is set up in such a way as to make detailed review of balances by months possible, the auditor should supplement his comparative review by scrutinizing the amounts charged to specific accounts month by month. This gives him an opportunity to discover whether individual months are out of line. An item for $50 may not appear important in relation to the total of an expense for a year, but in proportion to the charges for one month it may attract more attention. Also, by direct reference to the ledger accounts, an auditor can give attention to the source of the postings to the ledger accounts and select for investigation those which come from sources other than the voucher register or purchases book.

It should be clear that in making his review of the expense and income accounts, an auditor must have a sound background of knowledge of business conditions in general and of the operations of the particular firm under examination. If he has such a knowledge, his review constitutes a useful and important part of the verification program.

A combination of complete and partial account analysis with a careful review of the income and expense accounts, after giving attention to all income and expense accounts directly related to balance sheet accounts, provides an auditor with a sound basis for coming to a conclusion as to the reliability of the accounting data contained within them.

PROBLEMS—CHAPTER 14

Problem 14–1. Explain how you would proceed to discover irregularities in cash payrolls when it is suspected that the following conditions exist:

1. Employees released have been continued on payrolls for one or more weeks beyond date of release.
2. Wages paid to casual labor through paymaster's cash fund have been reimbursed to paymaster twice, once by reimbursement of payments made out of the paymaster's fund and again through the usual payroll channels.
3. Wages not claimed by employees have been misappropriated by the paymaster. (AIA)

Problem 14–2. In making an annual audit of a company you notice in going through the general ledger that there are several accounts which are not included in the trial balance of the company either at the first or at the close of the year because there were no balances in the accounts at either date. The accounts are in the section of the ledger where prepaid and deferred charges are kept and include accounts such as Contributions, Dues and Subscriptions, and Development Expense. State what interest, if any, you would have in these accounts; what you would do with the accounts, if anything; and the reasons for your answers. (AIA)

Problem 14–3. In making an audit of a business, you find that there is included in the income accounts a credit balance of $6,325 which is identified as "Net Gain or Loss on Disposal of Fixed Assets." Give in detail the procedure you would follow in the verification of this account. (AIA)

Problem 14–4. State what auditing procedures should be followed, including what documents you would wish to inspect, in determining the correctness of: (*a*) wages; (*b*) sales allowances. (AIA)

Problem 14–5. In connection with an annual audit of a corporation engaged in manufacturing operations, it is customary to read the minutes of the meetings of the stockholders and of the board of directors. Name ten important items that might be found in the minutes of meetings held during the period under review which would be of interest and significance to the auditor. (AIA)

Problem 14–6. You are engaged in making the audit of a corporation whose records have not previously been audited by you. The corporation has both an independent transfer agent and a registrar for its capital stock. The transfer agent maintains the record of stockholders, and the registrar checks that there is no overissue of stock. Signatures of both are required to validate certificates. It has been proposed that confirmations be obtained

from both the transfer agent and the registrar as to the stock outstanding at the balance sheet date. If such confirmations agree with the books, no additional work is to be performed as to capital stock. If you agree that obtaining confirmation as suggested would be sufficient in this case, give the justification for your position. If you do not agree, state specifically all additional steps you would take and explain your reason for taking them. (AIA)

Problem 14–7. Auditing a corporation in the State of X for the calendar year 1954, you find on its profit and loss statement: "Taxes paid, $4,200." The ledger account shows the following items:

Feb. 1	State real estate taxes, ½ of 1953	$1,200	
May 1	State real estate taxes, ½ of 1954	1,200	
Nov. 1	State real estate taxes, ½ of 1954	1,800	
Dec. 31	Contra to profit and loss		$4,200

Supporting tax bills show that the assessments cover a period for one year from July 1, agreeing with the state's fiscal year, the taxes being due and payable in two installments, November 1 and May 1. You also discover an unrecorded, unpaid bill for a state franchise tax of $3,000, due and payable November 1, 1954, for one year in advance. Give your analysis of the items, and state how they should be treated. (AIA)

Problem 14–8. In 1945, your client, a corporation, issued 100,000 shares of cumulative preferred stock. In 1947 it repurchased 20,000 of these shares and held them as treasury stock until 1952 when it sold them at cost. Dividends for 1950 and 1951 on the preferred stock were suspended, but were declared in 1952 together with the dividend for that year. You find that the dividends on the 20,000 shares of treasury stock for 1948 and 1949 were entered on the books as income to the corporation, as were also the suspended dividends when declared in 1952, the purchasers of record of these shares receiving only the dividend for 1952. How will you deal with this matter? Give your reasons. (AIA)

Problem 14–9. Explain briefly the procedure to be followed in verifying the capital stock for the purposes of the usual annual audit. (AIA)

Problem 14–10. How should an auditor verify the book record of: (*a*) directors' fees; (*b*) officers' salaries; (*c*) commission paid to officers; (*d*) officers' traveling expenses. (AIA)

Problem 14–11. Outline an auditing procedure for the verification of the issued capital stock of a corporation which does not employ an outside registrar or transfer agent, and which you are examining for the first time. Also outline a procedure for subsequent examinations. (AIA)

Problem 14–12. Name five typical expense accounts an examination of which may be of significance in the verification of specific balance sheet accounts, and explain, in each case, the nature of errors in the expense accounts, adjustment of which would affect the balance sheet as of the close of the year in which the entries were made. (AIA)

Problem 14–13. Briefly describe the audit procedure that suggests itself in the examination of: (*a*) tuition income of private schools; (*b*) rental income of office buildings; (*c*) annual dues of golf clubs; (*d*) donations to charity organizations; (*e*) plate collections at church services. (AIA)

Problem 14–14. You are examining annual financial statements which are to be published for the information of the company's stockholders. You find that depreciation charged against income differs from the depreciation deduction in the federal income tax returns. What would you do about it? (AIA)

Problem 14–15. How would you verify treasury stock as shown by the client's records? (AIA)

Problem 14–16. State the audit steps in checking income of: (*a*) an investment trust; (*b*) a public hospital; (*c*) a private school for boys. (AIA)

Problem 14–17. The Eaton Company was incorporated July 10, 1954, with an authorized capital stock as follows:

Common stock, Class A, 20,000 shares, par value $25 a share.
Common stock, Class B, 100,000 shares; par value $5 a share.

The capital stock account in the general ledger is credited with only one item in the year 1945. This represents capital stock sold for cash, at par, as follows:

Class A, 12,000 shares.
Class B, 60,000 shares.

The sum of open certificate stubs in the stock certificate books at December 31, 1954, indicates that 82,000 shares of stock were outstanding. (*a*) State possible explanations for this apparent discrepancy. (*b*) State the steps you would take to determine the cause of the discrepancy. (AIA)

Problem 14–18. The Standard Manufacturing Corporation sold 10,000 shares of preferred stock at 90 in 1953. The preferred stock is without par value, has a preference as to assets of $100 a share, and is convertible into common stock in the ratio of one share of preferred to two shares of common. The common stock has a par value of $20 a share. The corporation has ample earned surplus, and, by action of the board of directors in De-

cember 1953, subsequently approved by the stockholders, $100,000 of earned surplus was appropriated to bring the preferred capital stock account up to the liquidating value of $100 a share. During the year 1954, 1,000 shares of preferred stock, recorded on the books at an aggregate value of $100,000, were converted into 2,000 shares of common stock, having an aggregate par value of $40,000.

A states that the difference of $60,000 should be credited to earned surplus as a partial restoration of the previous charge of $100,000. *B* says the credit should go to the capital surplus until such time as there is available the full amount of $100,000 for transfer to earned surplus. *C* says that the credit to earned surplus should be at the rate of $10 a share on the 1,000 shares of preferred that were converted into 2,000 shares of common, or $10,000, thereby reducing the $100,000 previously charged. In as much as this is the first year conversions of preferred stock into common stock have taken place, it is desired to establish a definite policy for the future, and for this purpose *A*, *B*, and *C* come to you for advice. What treatment would you recommend? Give reasons. (AIA)

Chapter 15

INTERNAL CONTROL AND THE AUDIT PROGRAM

In Chapter 5 and at various points throughout this book the statement is made that, in determining the extent of his tests and the appropriate application of his basic techniques through audit procedures, an auditor is directly influenced by the extent of the internal control in existence. That is, he must increase or reduce the extent of his work in accordance with the absence or presence of effective internal control procedures in the company under examination. This means that an auditor must have a comprehensive understanding of the nature of internal control and its analysis as well as of his available techniques and procedures. Now that we have completed a study of the various procedures that an auditor may apply in the course of an audit examination it may be well to give some additional attention to the nature and procedures of internal control, its review by the auditor, and the effect that his conclusions as to its effectiveness may have on his audit program.

Auditor's Analysis of Internal Control. It is not enough that an auditor know what constitutes a good system of internal control. His peculiar task is to study the internal control system he finds in existence in the company he is examining and to discover any weaknesses or failures in that system that make errors or irregularities a possibility. Just as he does not make entries, post to the ledgers, or do other internal accounting work, so he does not install systems of internal control. He analyzes the financial statements to determine whether or not they are fair representations of the facts they purport to portray. In the same way he analyzes systems of internal control to discover in what respects they may be deficient.

It is true that an independent auditor, after he has completed his examination, may be requested to improve a system of internal control or even to design and install a new one. When he does this, however, he is acting in the capacity of an accountant, not that of an auditor. As an auditor his interest in internal control is an analytical one aimed at

determining to what extent his audit program should be reduced or increased because of the effectiveness or ineffectiveness of the controls in operation.

Extent of the Auditor's Review of Internal Control. The American Institute of Accountants has described internal control in the following terms:

> Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote managerial efficiency, and encourage adherence to prescribed managerial policies.[1]

This is an extremely broad definition of internal control and one that is useful in indicating its general nature and its tendency to pervade almost all aspects of a company's organization and operations. Under this definition such matters as budgetary control, personnel training programs, and time and motion studies would be included. Obviously the auditor's interest in internal control cannot carry him into such areas as these. Along with this broad interpretation of internal control there exists another and more restricted interpretation that might be called accounting control. This has to do with those measures directed at obtaining accuracy in the financial statements and accounts. This is a much narrower definition, yet one sufficiently broad to call for careful investigation by the auditor and to give him a sound basis for developing his audit program. It is safe to say that in most cases when an auditor speaks of reviewing the internal control of a company under examination he is speaking of that part of the internal control that relates directly to the financial statements and their general accuracy and reliability. He is not unaware of the broad interpretation of internal control; he realizes, on the other hand, that it is impracticable and indeed unnecessary for him to make an investigation as extensive in scope as would be required if the broad interpretation were adopted for this purpose.

Deficiencies in Internal Control. Weaknesses or deficiencies in internal control may consist either of the omission of essential control steps or in the improper performance of such steps. That is, inclusion of a control measure in the company's manual of operations is no as-

[1] *Internal Control,* a special report by the Committee on Auditing Procedure, American Institute of Accountants, p. 4.

surance that the step is carried out as it should be to constitute an effective control procedure. Thus we must be alert both to the omission of control procedures and to their inadequate performance.

The omission of a specific internal control procedure is not always a weakness. In some cases other internal control steps may be effective in reducing the possibility of errors, although a specific step that could have been used is omitted. For example, daily deposit of cash receipts intact is commonly considered to be an important feature of the internal control over cash receipts. However, it is entirely possible that the presence of other control procedures might permit a company to deposit no oftener than once a week and perhaps even to make disbursements from receipts before deposit. Of course, these additional procedures would have to be carefully established and carried out efficiently, yet they could under some conditions substitute for the daily deposit of receipts intact. So it is with other audit procedures as well. There are relatively few internal control procedures that are absolutely essential in and of themselves.

On the other hand, the absence of a common and useful control step is presumptive evidence that the internal control is not as good as it would be if that step were included. Therefore, we should know what the applicable procedures are, and when we discover that one is missing we should immediately extend our investigation. If we find that other control procedures do effectively substitute for the missing step, well and good. We may conclude that the internal control is satisfactory. If we find no other procedures which can be considered to replace the missing step, then we must conclude that the internal control is unsatisfactory.

Thus our review of internal control is, first of all, directed at discovering whether any of the essential features of internal control are missing in the situation under examination. This means we must have a sound understanding of what the common features of internal control are and what their purpose is. A beginning textbook in auditing cannot deal exhaustively with internal control any more than it can enter into a complete discussion of accounting principles and practices. However, some familiarity with the most useful steps in internal control in those areas an auditor deals with is necessary as a background to any discussion of the influence of internal control on audit programs. For that reason the following paragraphs enter into a brief and elementary discussion of the important internal control features in the various areas we have studied.

Important Features of Internal Control over Cash Receipts. The problem of accounting for cash receipts varies greatly from one type of business to another, and the methods of attempting to obtain control over cash receipts will vary to the same extent. In general, however, there are certain features of every good system of internal control over cash receipts. These include the following:

1. Preparation of a controlled listing of all cash received immediately on receipt or as soon thereafter as possible and comparison of the list with cash book entries and bank deposits. Such a list may be prepared as a cash register tape, as duplicate copies of receipts issued for remittances received, or as a list of remittances prepared by the person who opens the mail. It should be prepared as soon as the cash is received in the company's control and should be prepared by someone who has no other functions with respect to cash handling or recording. Later this list should be compared with the cash receipts book entries and with bank deposits by someone entirely independent so that any failure to record or to deposit all cash received will be discovered.

2. Daily deposit of all cash received to discourage temporary borrowing and to facilitate comparison of cash book entries with bank deposits. The practice of depositing receipts without diminution for expense payments is desirable to control disbursements as well as receipts.

3. Preparation of an independent bank reconciliation. Failure to deposit all cash received and recorded will be brought to light only if a bank reconciliation is prepared to discover any differences between book and bank balances of cash on deposit. Of course, a bank reconciliation is useful in discovering unintentional errors also.

4. Adequate separation of duties with respect to (*a*) receiving and handling cash, including preparation of bank deposits, (*b*) recording cash transactions, including accounts receivable bookkeeping, and (*c*) preparation and approval of bank reconciliations. If the person who handles cash also records it in the cash receipts book or has access to the accounts receivable ledgers he has an opportunity to cover any cash he has abstracted by means of intentional errors in footings, postings, forwardings, and the like. He can also practice lapping, if he has access to the accounts receivable, or may introduce fictitious account balances, force a reconciliation of the subsidiary with the controlling account when it actually does not balance, and the like. Thus separation of recording and handling cash is essential. In the same way, if the person who handles cash prepares the bank reconciliation he can cover shortages in the cash on deposit by manipulation of the bank reconciliation to make

it appear as though the bank balance supports the book balance when actually it does not.

Internal Control Measures for Cash Disbursements. The principal categories of cash disbursements are those made through petty cash, those made through general cash disbursements, and those for payroll purposes. Each of these requires separate attention.

The internal control features over petty cash disbursements would include:

1. Use of an imprest system to limit the amount available to the petty cash custodian at any time and to permit the development of procedures for approving disbursements and reimbursements.

2. Use of petty cash vouchers to provide a record of disbursements, approvals of the disbursements, and responsibilities for them.

3. Requirement of approval of every disbursement before reimbursement so that petty cash cannot be expended or otherwise disposed of improperly without fear of discovery.

4. Cancellation of petty cash vouchers at reimbursement so that they cannot be submitted for reimbursement more than once by changing dates or otherwise manipulating them.

For general cash disbursements the following measures are useful:

1. Use of checks for all disbursements to limit the number of persons who may make disbursements, to provide a record of every disbursement, and to fix responsibility for every disbursement made.

2. Preparation of an independent bank reconciliation monthly to provide a review of every check issued and to assure that all checks have been entered and recorded properly.

3. Adequate separation of duties with respect to (*a*) approval of invoices for payment, (*b*) check preparation, (*c*) check signing, (*d*) check distribution, (*e*) recording cash disbursements, and (*f*) preparation and approval of monthly bank reconciliations. The employee who approves invoices for payment, for example, should have no access to checks so that any temptation to approve fictitious invoices will be removed. The employee or officer who signs checks should not initiate their preparation but should sign only those that have been submitted to him and then only if they are supported by an approved invoice or other documents. Check distribution is best handled separately from invoice approval and check preparation so that those who have had to do with initiating preparation of a check are not able to obtain it after signature and convert it to their own use. Otherwise they may initiate fictitious invoices or make checks payable to fictitious payees. If those who sign checks

have access to the cash disbursements record they may cover cash shortages brought about by unrecorded checks with intentional errors in footings or postings and the like. Finally, if the bank reconciliation is to be a real proof of the book figures of cash it must be prepared by someone who could not easily benefit by its manipulation.

In making payroll disbursements the following control features should be observed:

1. Use of checks for all disbursements for the same reasons as given under general cash disbursements.

2. Review and approval of payrolls, including hours worked, rates of pay, overtime hours, deductions, and the like before payment so that any flagrant attempts at padding or misstating essential facts may be discovered. If the payroll consists of a great number of employees it may be necessary to have different individuals review the payroll for different departments or sections.

3. Preparation of an independent payroll bank account reconciliation monthly. This is required for payroll cash as well as for general cash. If the payroll transactions are handled through a general bank account instead of through a special account no additional reconciliation is required, of course. This is an awkward procedure, but its use cannot be said to affect seriously the internal control over payroll disbursements.

4. Adequate separation of duties with respect to (*a*) hiring employees and establishing rates of pay, (*b*) approval of hours worked, (*c*) payroll preparation including listing employees, entering hours and rates, extending, and footing, (*d*) check signing, (*e*) check distribution, and (*f*) bank reconciliation. Hiring employees must be separated from all other steps so that no benefit can come to the responsible person if he adds fictitious names or names of friends or relatives to the payroll. Approval of hours worked must be sufficiently independent of other steps so that the responsible person cannot benefit from approving hours for fictitious or separated employees. The mechanics of payroll preparation, which normally includes the preparation of checks as well, must be separated from any access to signed checks so that fictitious checks or checks made out for excessive amounts cannot benefit the employee responsible. Check signing and check distribution must be controlled carefully so that those who are responsible for the preceding steps have no hope of getting possession of signed checks which they have initiated improperly. Finally, bank reconciliation as always must be completely independent if it is to be an effective check on disbursements and the balance as shown on the books.

Internal Control Procedures for Sales and Receivable Transactions. Special attention must be given to the internal control over sales and receivables because of the relationship of these transactions to inventories and cash, each of which may be converted to personal use with little difficulty. In addition, carelessness in the processing of sales invoices may result in a failure to bill customers for shipments, thereby causing direct loss to the company. Thus the purpose of internal control over sales and receivables should be to obtain some assurance that shipments are made only to sound credit risks and on the basis of approved sales invoices, that a receivable is recorded for every shipment, and that accounts receivable, once recorded, are credited only for remittances or for duly authorized returns, allowances, or write-offs.

1. Serially numbered sales orders should be prepared and approved for every sale and should be subsequently accounted for so that none are lost or misplaced. Preparation and approval should be separated, and approval should take place before the sales order or copies of it are sent to the shipping and billing departments. This is designed to preclude the preparation of fraudulent sales invoices intended to obtain the shipment of merchandise after which they will be destroyed. Later accounting for all sales invoice numbers after entry in the sales record assures that none has been lost and that an account receivable has been recorded for every shipment. Review of the sales orders should include a review of the credit rating of the customer, so that shipments are not made to unapproved credit risks, and a review of the prices, terms, and arithmetical accuracy of the sales order. If copies of the sales order are used as advices to the shipping department and to the accounts receivable department, approval of the sales order may be indicated on these copies and gives effective assurance that these departments have received accurate information about the transaction.

2. Shipment of merchandise should be made only on the basis of written approval from the sales department and a record of all shipments made should be kept for later comparison with sales orders and entries in the sales record. Some means of checking the work of the shipping department to discover any unauthorized shipments is desirable; this may take the form of inventory controls, review of shipping documents, or other similar measure.

3. In billing customers, that is, preparing invoices and making charges to the customers ledger, all sales orders and shipping documents should be accounted for by number or otherwise so that none is omitted; numbered sales invoices should be used so that they too can be accounted for; any credits posted to the customers ledger should have

proper authorization based on an examination of receiving reports for returns, and review of the original sales order and sales invoices for allowances.

4. In recording sales invoices in the sales record, only approved charges and credits should be entered and all sales invoices should be accounted for.

5. In accounting for receivables after they have been charged for sales, monthly statements should be sent to all customers under conditions that make it impossible for anyone who has manipulated the customers' accounts to suppress the preparation or delivery of statements or to intercept and destroy replies; the subsidiary customers ledger should be reconciled with the controlling account monthly by someone independent of the actual bookkeeping work so that errors, whether intentional or not, will be disclosed; provision should be made for aging the accounts periodically and for investigating all overdue balances; the write-off of uncollectible accounts should be authorized by someone in authority who has had no opportunity to convert receipts to his own purposes.

6. Receivables, whether notes or accounts, should be given adequate physical protection against damage and against unauthorized entry by those who might have a desire to make such entries.

7. Appropriate separation of duties should be provided so that unauthorized shipments cannot be covered through the destruction of sales or shipping documents or through the improper crediting of the accounts resulting therefrom. Those who keep the accounts receivable ledger should certainly not have access to any of the receipts from customers because of the opportunity thus afforded them to manipulate the accounts and so conceal any remittances they may have converted to their personal use.

In some situations, such as in gasoline stations and chain stores, where a small number of uniform products or a large number having the same rate of mark-up are handled, effective internal control over sales is obtained by making the sales outlet accountable for the retail price of all merchandise it receives, thus joining inventory and sales control measures.

Internal Control Procedures for Purchases and Accounts Payable. In most business concerns the approval of an invoice for payment almost automatically calls for the preparation and issuance of a check. Thus, one of the most important steps in cash disbursement is the processing and approval of vendors' invoices. There is the additional problem that

unless careful control is exercised over vendors' invoices the accounts payable may be understated in terms of the items included in the physical inventory and various expense items may be charged against the wrong accounting period.

In obtaining satisfactory control over transactions involving purchases and accounts payable some attention must be given to each of the following:

1. All purchases should be based on purchase requisitions initiated by those having appropriate authority, such as department heads or their subordinates. Purchase requisitions should be in writing, serially numbered, and should carry the signature of the authorizing officer. They should be reviewed carefully by the purchasing agent before issuance of a purchase order.

2. Purchase orders are best issued through one central office. They too should be prenumbered, each number should be accounted for, and all should be supported by authorized purchase requisitions.

3. Incoming merchandise should pass through a receiving department in which a receiving report is prepared for each shipment. Some provision should be made for immediate follow-up of damaged or unsatisfactory merchandise received.

4. Vendors' invoices should be forwarded immediately on receipt to an employee, commonly a member of the accounting department, for approval. He should match the invoice with a copy of the receiving report and a copy of the purchase order to make sure that goods have been received as ordered and in satisfactory condition. The invoice should also be reviewed at that time for terms, prices, and extensions. If all are in order it may be approved for payment. Through indications on the invoice itself or on an accompanying sheet, provision should be made for distribution of the charge involved to the various appropriate expense or purchase accounts. The invoice should then be filed chronologically under date of payment.

5. No invoices should be entered as payable until after approval as described in the preceding paragraph. At least monthly some provision should be made for reviewing all outstanding invoices and reconciling them with the general ledger accounts payable account. Outstanding purchase orders should be reviewed periodically also and action taken to clear any which have been outstanding for a long time.

6. As in every phase of accounting, adequate separation of duties should be provided. This includes separation of the issuance of the purchase orders and the duty of receiving incoming merchandise so that items ordered will not be ordered for personal use. Those who issue

purchase orders likewise should not be in a position to approve invoices for payment. Someone other than the employee who approves invoices for payment should have the task of recording them so that he may make a final check on the existence of all required approvals at that time.

Internal Control Measures Relating to Inventories. In a sense, inventories constitute a portion of the internal control problem of both sales and purchase transactions; in another sense they present a problem all their own. For discussion purposes it is preferable to think of inventories as presenting a control problem separate from either of these other areas, but as a practical matter it must always be kept in mind that unless the control over sales and purchase transactions is adequate there can be little assurance of satisfactory internal control over inventories.

Two principal steps are required in the adequate protection of goods on hand. They are:

1. The prevention of unauthorized shipments through separation of the duties of stock handling and inventory accounting, thus making it difficult to manipulate the inventory records to conceal unauthorized shipments or withdrawals, together with some provision for periodic independent counts to discover whether the quantities indicated by the records are actually on hand. Of course, any material differences located in this way must be followed up if this internal control measure is to be effective.

2. Physical protection of goods on hand should be provided for through the establishment of secure storage facilities accessible only to those employees responsible for the safekeeping of the stock of merchandise. Responsibility for inventory safekeeping should be centralized in a single employee. Any withdrawals from stores for any reason should be made on the basis of approved requisitions only, and physical counts should be made periodically to discover whether the responsibility for safekeeping is discharged as it should be. Physical protection from the weather, from careless handling, and from similar causes of deterioration should be considered equally as important as protection from theft or improper conversion in many cases of valuable or delicate merchandise.

Internal Control Measures for Investments. The common internal control measures for securities owned generally consist of:

1. Some provision for safekeeping of the documents such that no one person has sole access to them. This is ordinarily accomplished by plac-

ing the certificates in a safe deposit box with the stipulation that the signatures of two officials are required to gain access to the box.

2. An independent record of the securities owned is kept, generally by a member of the accounting department, and occasional counts are made to check the certificates on hand against the counts.

3. Transactions in securities usually call for the action of the board of directors or of a special committee, and in every case the responsibility for completing the transaction is definitely fixed.

4. Income from the securities owned is verified by someone in the accounting department who computes the income that should have been received based on the independent record of investments owned together with a published dividend and interest record.

5. All securities owned are made out in the name of the company and are so registered with the issuing company.

Internal Control Measures for Fixed Assets. The chief problems in obtaining internal control over fixed assets have to do with reducing the possibilities of error in distinguishing between assets and expenses. There is also the possibility that transactions will be entered into without authorization and that the proceeds from sales of retired assets will be misappropriated. Measures providing for systematic authorization and reporting of all property transactions are required if any satisfactory control is to be maintained. All additions and retirements should have authorization of one kind or another, copies of which are forwarded to the accounting department so that its members may investigate the subsequent handling of the transaction and make appropriate entries. Subsidiary property records should be kept both to help control transactions and to assure that depreciation provisions and retirements are recorded correctly. There usually is little difficulty in obtaining a record prepared independently of those who enter into the actual transactions, so that there is somewhat less danger of illicit transactions here than in other areas of a company's transactions.

Other Important Internal Control Measures. In addition to the measures mentioned as applying to specific types of transactions, there are certain general measures of considerable importance. Among these are:

1. Separation of general ledger accounting from other phases of the accounting work so that any errors in subsidiary records will be revealed when they fail to reconcile or agree with general ledger balances and so

that general journal entries cannot be used to cover shortages or other irregularities.

2. Separation of the financial and accounting organizations so that there is no combining of incompatible duties at any level. For example, if the treasurer is also placed in charge of all accounting work, the accounting department cannot be regarded as constituting as effective a check on financial transactions as if it were administered by an independent officer such as a controller.

3. Provision should be provided for specific responsibility for and authorization of all important transactions so that all significant decisions are subjected to appropriate scrutiny and control.

4. Appropriate utilization of accounting machines should be made to reduce the probabilities of mechanical errors.

5. Appropriate use of safekeeping facilities for accounting documents, records, and other valuable papers is essential.

6. An internal audit department is desirable to test the conduct of operations and to make investigations where appropriate.

Effect of Internal Control on the Audit Program. The preceding paragraphs are not intended to be a complete exposition of internal control measures. As mentioned at the beginning of this chapter, any such attempt should constitute a book in itself. These paragraphs are sufficient, however, to give a basis for discussion of the effect which their presence or absence in a given situation may have on the determination of the auditor's verification program.

The first point to be noted in studying the influence of the degree of internal control on an audit program is that some tests and procedures are of such nature that they should not vary with the degree of internal control. For example, the cash account should be footed and balanced for the year; certainly there is no point in performing this procedure more than once for any given year and there is no other way in which that specific procedure can be expanded or reduced. In the same way the reconciliation of the subsidiary accounts receivable ledger with the control account, the examination of security certificates, obtaining a bank confirmation, and similar steps must be taken regardless of the extent of the internal control. Thus we must remember that the internal control in existence does not govern the extent of use of every procedure we apply but only of certain ones.

Other tests, of course, may vary considerably. The extent to which we foot the cash disbursements book, for example, may vary from a very small test to the entire year. The extent of our test counts of inventory

quantities, the number of accounts receivable balances that are confirmed, the number of invoices that are examined in support of additions to fixed assets—all these may vary tremendously in any given situation.

In connection with these tests that can vary so much it should be pointed out that unless the internal control is exceptionally good as indicated by past examinations and a thorough review currently, most of the procedures discussed in this book will be applied to at least a minimum extent. Some application of most of these procedures is required if for no other reason than to discover whether the internal control is really functioning as it should. Even if the internal control is considered to be good it is desirable to test footings of the books of original entry, trace postings, examine some documents, confirm some account balances, and count a few inventory items to gain additional assurance that the internal control is functioning as we believe it to be. In most cases the period selected for tests that relate to the performance of bookkeeping functions such as footing and posting or the entering of transactions will be a month, not because a month is important quantitatively, but because it represents a bookkeeping cycle and can be proved as a unit. For such matters as payrolls, a pay period may serve equally well. For such items as customers' accounts and inventory quantities there is no ready guide for a minimum test and the selection of a quantity for test may be more difficult. Here the effort should be to make a reasonable test. This is indefinite, of course, but when it is remembered that in each of these and in such other cases as additions to fixed assets it is normally possible to get a large dollar proportion of the total with a reasonably small number of items, no great problem is found.

What all this means, of course, is that most audit tests cannot be reduced to zero regardless of the extent of internal control. We can never be certain that the internal control is functioning adequately until we test the records that are the result of the internal control. Thus some testing must be applied in almost every case so that the range within which the internal control situation is effective in increasing or decreasing the amount of audit work is generally from a minimum test of one month or similar period or quantity to a maximum of the entire year or to all data of a particular type.

Little help can be given at this point with respect to the maximum extent of any given test. Variations in internal control are such that any rules would be useless and might be harmful. As one gains experience under the guidance of someone who is already experienced in such matters, he will gradually acquire the ability to judge reasonably well the amount of additional work that is justified. Rarely is it neces-

sary to apply any procedure for an entire year unless fraud or substantial error has definitely been proved and only the extent of the error is in question. Frequently the minimum work will be increased by from two to six times because of weakness in the internal control but seldom more than that. The goal, of course, is for the auditor to satisfy himself that under the conditions as they exist no material error or irregularity is present. To the extent that he does find errors and irregularities he should continue to expand the extent of his procedures.

Adaptation of Audit Program to Internal Control Situation. In adapting an audit program to a given internal control situation, an auditor must develop a line of reasoning illustrated by the four following questions:

1. What features of internal control are missing?
2. What errors and irregularities are thereby possible?
3. Which audit procedures will be of most help in discovering whether such errors and irregularities have been committed?
4. To what extent should these procedures be applied?

It is not practicable here to work out an answer to the last three of these questions under the assumption that each of the control features mentioned in the preceding sections of this chapter is absent. It is also doubtful if much benefit would be derived from reading such a discussion. More important to the potential auditor is development of an ability to do such reasoning on his own. For that purpose examples are presented in the remaining paragraphs of this chapter to illustrate the selection of specific procedures in view of specific weaknesses in internal control.

Assume, for example, that in the company under examination the bank reconciliation is prepared by the same individual who signs checks. In such a case he could write company checks to his own order, cash them for his personal benefit, destroy the check when it was returned by the bank, and manipulate the bank reconciliation so that the shortage was not apparent. This means that, when an employee has such an opportunity, the auditor must exercise additional care in his review of bank reconciliations and review more of them than he otherwise would. He should also account for all check numbers used in each of several months, and should reconcile disbursements recorded in the cash book with disbursements shown in the bank statement for several months.

If no attempt is made to cancel petty cash vouchers after the petty cashier has been reimbursed for the amount of the disbursement, it is

possible that the reimbursed vouchers will be removed from the files and with the date changed will be submitted for reimbursement the second or third time. In the presence of such a possibility the auditor should call for the files of reimbursed petty cash vouchers and examine them with particular attention to discover whether any have been removed to be submitted a second time. This requires that he reconcile the total petty cash vouchers supporting each reimbursement check with the total of the reimbursement check to make sure that all petty cash vouchers can be accounted for.

Perhaps a situation might exist in which inadequate attention was given to the approval of vendors' invoices before payment although other internal control measures make it virtually impossible for an employee to put through fictitious invoices and then obtain signed checks for them. In such a case there may be very little danger of fraud on the part of employees; on the other hand, there may exist a very good chance that the company will pay invoices for which unordered or damaged merchandise was received or which perhaps were sent to the company in error. In such a situation the auditor should make a special review of paid invoices for a period of two or three months to discover whether or not the invoices paid during the period represent legitimate purchases of the company under examination. He should also match the paid invoices with receiving reports or such other information as may be available to discover whether payment has been made for merchandise or services that were never received.

PROBLEMS—CHAPTER 15

Problem 15–1. In the examination of a large cafeteria in which all customers pay their checks to a single cashier you find that the cashier also prepares and makes the daily bank deposits. She submits a copy of each deposit ticket to the accountant so he can record the daily cash receipts. What audit procedures would you apply in such a case as this? To what extent?

Problem 15–2. It is the practice in the Jonas Printing Company to send invoices received from suppliers directly to the department heads concerned for their approval. After approval the invoices are sent to the accounting department for payment. What problems do you find here from an audit point of view? What verification measures do you recommend?

Problem 15–3. The Kitchen Equipment Manufacturing Company manufactures kitchen installations for restaurants, churches, and institutions. It has a relatively small number of customers at any one time and employs only about fifty employees. Miss Abigail Edwards, treasurer of the company, takes care of all accounting work, opens all mail, prepares bank deposits, payrolls, bank reconciliations, and the like. The company has no cost accounting system and no detail stores or raw-materials accounts. Work in process cards are kept by the production superintendent. What audit procedures would you stress, and to what extent would you apply them in such a situation?

Problem 15–4. A manufacturing company has several thousand dollars in miscellaneous stocks and bonds. These are kept by the treasurer of the company in a safe in his office. Transactions in securities are authorized by the board of directors, of which the treasurer is a member, and are carried out by the treasurer. All income from the securities is forwarded to the treasurer who then turns the cash in to the cashier, a member of his own department, for deposit, and forwards an advice of the receipt to the accounting department for entry. The only detailed record of the securities owned is a memorandum record kept by the treasurer. What verification procedures would you employ in your examination of the securities and security transactions in connection with an annual audit examination?

Problem 15–5. A men's clothing store in a small city has approximately five hundred accounts receivable, many of which are relatively inactive. The office staff consists of an accountant, a cashier, and two or more clerks. The accountant is in charge. The clerks do all the posting to the accounts receivable from lists of remittances supplied to them by either the cashier or the accountant. The cashier lists all cash received over the counter by

means of a cash register; the accountant opens all mail and lists remittances thus received. The clerks prepare trial balances of the accounts receivable ledger and submit them to the accountant each month. If they have trouble in balancing with the general ledger control the accountant works with them until the error is located. Statements are prepared by the clerks and are submitted to the accountant for review and mailing. Point out any weaknesses you see in this arrangement of duties and state the procedures you would recommend in an examination of the receivables.

Problem 15–6. The Easy Credit Department Store employs a full-time agent to collect past-due accounts receivable. The standard practice is for the credit manager to make all efforts to collect customers' accounts receivable, including collection letters, telephone calls, and the like, until the account is six months old. At that time accounts are turned over to the special collector and he continues to make personal calls on the customer until either the amount has been collected or he is certain that no additional amounts can be collected. Once a month he prepares a report recommending the write-off of those balances which he has determined are uncollectible. Any cash collected is turned in to the cashier daily. If you were assigned to audit the accounts of the Easy Credit Department Store, what attention would you give to this situation?

Problem 15–7. The Electrical Appliance and Fixture Company handles a wide variety of electric equipment on a wholesale basis and also operates a retail outlet in conjunction with its warehouse and office. The inventory amounts to a considerable sum at all times. Detailed inventory records are kept by the storekeeper. All purchases are charged to a Purchases account in the general ledger, and no attempt is made to record the inventory or to determine cost of goods sold until the year end, when a careful physical inventory is taken. The stockroom is large, well-equipped, locked, and under the close supervision of the storekeeper and his assistant. Appliances are issued to the retail outlet only on the basis of signed requisitions which are then kept by the storekeeper in his files. Shipments to wholesale customers are handled by a shipping department under the direct supervision of the storekeeper. Discuss the adequacy of the internal control in this situation, and describe the audit procedures you would apply in an examination of the inventory.

Problem 15–8. You are assigned to audit a branch store of a large chain of retail shoe stores. The store you are to examine is in the business district of a large city. It is a one-room store with shelves lining the walls, and has a cash register and desk at the rear of the store. The manager is the chief salesman and has one regular assistant. At certain times additional salesmen are employed on a temporary basis. The manager deposits the cash

receipts for each day in a bank account the following day. Withdrawals from this account can be made only by the main office. A fixed amount for change is kept on the premises and locked up each night in a wall safe. To what matters would you give special attention and what audit procedures would you apply in completing your examination?

Problem 15–9. The City of Mayville is small and has only a small office staff. All cash disbursements are made and recorded by the city treasurer. As bills are received he checks them with actions of the city council to make sure that they are properly authorized. If he finds that they are, he issues a check and stamps the bill "Paid," filing it away for reference. His other tasks include preparation of the bank reconciliation. All checks are numbered, and a carbon copy of each check is made and filed in a ring binder which serves as the cash disbursements book. State in some detail the procedure you would follow and the extent of your examination.

Problem 15–10. Mr. Enilosag owns several service stations in a large city. Each of these is operated by a manager who has complete charge of the station including hiring such additional help as he needs, approving bills for payment, etc. All cash disbursements, including payrolls, are paid through a central office on the basis of approved invoices or payrolls sent in by the station managers. Daily cash receipts are picked up at the individual stations by a cashier from the central office each day and deposited. Careful records are kept of the gasoline purchases for each station and are reconciled on a gallonage basis with the cash receipts. Payrolls submitted by the station managers are carefully scrutinized on a comparative basis as are all other invoices or requests for checks. You are assigned to make an examination of the accounts for the entire enterprise. What procedures would you recommend be carried out at the various stations?

Chapter 16

COMPLETING THE EXAMINATION

As the detailed verification is brought to a close, it is necessary to consider the steps to be taken in completing the examination and the work papers. As the only information the auditor has available to him after he leaves the offices of the company under examination is that included in his work papers, it is important that he make sure before he leaves not only that his verification has been complete but also that he has in his papers all the information he needs to prepare his report.

The work of completing an audit examination after the basic verification has been completed can be divided into two separate although related parts. One has to do with the mechanical aspects of completing the work papers; the other has to do with audit review, which is an extremely important part of any examination.

Mechanical Steps in Completing an Audit Examination. Whether an examination is a complete verification of the data in the financial statements or is a specialized investigation directed at only one account or a small group of related accounts, certain efforts must be taken at the close of the examination to insure that no important steps in the verification or investigation procedures have been omitted and to make sure that there is sufficient information appropriately organized in the work papers to support the conclusions reached by the auditor. These more or less mechanical steps may be listed as follows:

1. Insure that each step in the verification program has been completed and signed for by the person doing the work.
2. Make sure that all adjusting journal entries recommended are complete, adequately explained, and have been posted to the general ledger trial balance if one is prepared.
3. Look over each supporting schedule to discover any weaknesses or deficiencies so that they may be remedied and each schedule may be complete and self-explanatory.
4. Check all cross referencing and indexing to make sure that it is complete and adequate to enable others to read and understand the work papers without undue difficulty.

5. If a general ledger trial balance is prepared, make sure that every item in it requiring the support of a separate analysis has been adequately supported.

To a considerable extent these are in the nature of mechanical requirements, yet each is important if a complete and satisfactory set of work papers is to result from the examination. The importance of audit work papers to the auditor can scarcely be overestimated. They are at once the basis on which his report is based, that is, the accumulation of information and evidence on which he draws in writing his report, and the best evidence he has as to the adequacy and performance of the examination. The only way that the supervising accountant can judge the work of his assistants is to study the work papers they have prepared in completing the work assigned to them and to ask such questions with respect thereto as appear necessary.

Because of the importance of work papers in the preparation of the audit report and in support of the facts and opinions stated in the report, considerable care is usually taken to eliminate any errors, inconsistencies, inadequacies, or other deficiencies in the work papers. The term given to the various measures that are designed to eliminate errors or deficiencies in the audit work papers and report is "audit review" or more simply "review." It should be noted that review embraces not only the mechanical steps above but also the more intangible problem of adequacy of the examination in view of the internal control and the situation as found.

Importance of Review in Auditing. The importance of audit review grows out of the related facts, first, that the audit work papers are both the basis for the audit report and the proof that an adequate examination has been made by each person assigned to the engagement; second, that accounting and auditing are of such a nature that errors in the handling of figures or in judgment as to the best treatment of a given item are not only possible but may also be significant in their effect. Audit review is directed at both of these points. First, there is the need for insuring that the work papers are as complete and as useful as possible. Second, there is the requirement that errors be eliminated or at least reduced in so far as possible.

Review consists almost as much of a frame of mind on the part of the reviewer as it does of the steps that he takes in performing his review; therefore a definition of this term is of little use. Rather it is necessary

to discuss the general features of audit review with an idea of understanding its intent and usefulness.

For purposes of discussion, audit review may be divided into two parts: work paper review and report review. Work paper review is carried out principally in the field, that is, in the office of the company under examination, and is directed at insuring that the work papers are complete, in good order, and adequately indexed, that the program meets the needs of the situation and has been completed, and that any questions raised by members of the audit staff during the examination have been answered satisfactorily.

The importance of completing the work paper review before leaving the client's office is apparent. If the verification is not complete, if additional steps are required, if more information is needed in the work papers, it will be well to discover this and remedy the situation before leaving the location where such verification can be performed and additional information obtained. It is not only embarrassing, it is also costly and often less effective, to return to the office of the company under examination for additional work after the audit examination is supposedly completed.

Work paper review is generally completed in two stages. The first stage consists of a review by the accountant in charge of the work of his subordinates. One of the responsibilities of the in-charge accountant is to see that his assistants perform their assignments efficiently and effectively. This he does by reviewing their work papers. He may do this on a piecemeal basis by reviewing every specific work sheet turned in by his assistants as they complete the various tasks assigned to them, or he may accumulate their work over a period of time and then review it all at once. The particular method to be followed is largely a matter of personal choice with the accountant doing the reviewing. The one firm requirement is that he complete the review while the man is still available to answer any questions and to make any corrections or improvements that the reviewer feels are necessary. Thus if there is any likelihood that an assistant may be called away before completion of the engagement, it is well to review his work before that time. Likewise, it is desirable to review the work of all assistants before the engagement is so close to completion that there is little reason to hold the men around until their work has been approved.

Just as the men completing a phase of the verification work indicate their responsibility by initialing the work paper that summarizes their work, so the reviewer initials the work paper to indicate that he has

accepted that work as being complete and satisfactory. Once the reviewer has done so, the responsibility for the adequacy of the verification becomes his. He cannot, of course, guarantee from his review of the papers that the assistant has, for example, carefully examined every document for the period indicated. He does imply by his initials that he feels the assistant has had proper instruction and that so far as he, the reviewer, is able to tell, the work has been completed satisfactorily.

The second phase of the work paper review is generally carried out at the completion of the verification work and consists of the review of the completed set of work papers by someone usually on a top supervisory level. The ideal time for such review is at the point when all verification work has been completed and before the audit report has been written. This gives the reviewer an opportunity to evaluate at one time all the work that has been done, with no loose ends to be investigated later. At the same time, any modifications or adjustments which he feels are necessary can be adopted without serious loss of time or without requiring changes in the audit report. Once the report has been drafted it becomes far more difficult to delete or add an adjustment because the adjusted figure must be incorporated in the report at perhaps several different points.

Report review may be carried out at the audit location, at least in part, but is generally performed in the auditor's own office. It has as its purposes to insure that:

1. The audit report is in agreement with the audit work papers with respect to all facts and figures included.
2. No assertions of fact are made in the report that are not adequately supported by the work papers.
3. The report is acceptable in so far as grammar, content, and form are concerned.
4. No mechanical errors exist in the finished report.

In order to accomplish these objectives, it is customary for the report to be reviewed once by a member of the top supervisory level in conjunction with the completed work papers. This accomplishes the first two purposes listed. Then a detailed clerical check of all footings, extensions, and amounts used at more than one point in the report is made to insure that the report draft is ready for typing. Then again after the report has been typed the same type of clerical check of all amounts, totals, and use of figures is made to determine whether any errors were made in typing and that no errors were previously overlooked. The

typed report is then forwarded to the supervisor, who gives it a last and thorough reading before releasing it for mailing to the parties concerned.

Out of this brief summary of the steps in review of typical audit examinations it is possible to point out two general requirements of the review process. First, review should always be conducted by someone superior in rank and experience to the person or persons whose work is under review; second, the work of every member of the audit team should be reviewed at least once. A few words may help to explain each of these more completely.

In obtaining an effective review, the attitude of the reviewer is almost as important as the steps he follows in performing his review function. If he feels that the man whose work he is reviewing is better qualified than he is himself, it is very unlikely that he will expect to find errors or deficiencies in the work and also unlikely that he will make any strong suggestions for improvement. If, on the other hand, he is reviewing the work of an assistant who is conceded to be inexperienced and less sound in judgment, the reviewer is far more likely to do a thorough and careful job of review and to make such suggestions as he feels are required.

In requiring that the work of every man on the staff be reviewed at least once, auditors are merely recognizing the nature of the materials with which they work. Possibilities for error in handling accounting data are many and varied, and the man who has done his best to produce accurate results may still have errors, either clerical or of a judgment nature, in his results. Further, once a man has done a piece of work it is almost impossible for him to adopt the attitude appropriate to a reviewer. As a man cannot audit his own work, so he cannot review it adequately. Someone with a more impersonal attitude and a fresh point of view on the work to be reviewed is required to give it the searching scrutiny it needs.

Attitude of Reviewer. Audit review is generally performed only by members of the audit staff who have acquired adequate experience and have developed judgment sufficient to enable them to evaluate the work of others. Yet every auditor is a potential reviewer because all look forward to advancement and additional responsibility. Only by developing the ability to review efficiently and well can one expect to advance on an audit staff; so it becomes important to the beginner to understand the nature and function of the task he someday hopes to assume. Also, the beginning auditor is more likely to perform his own assignments satisfactorily if he knows what is expected of him by those who will review his work. Thus on both counts it becomes important

for every member of the audit staff to have a familiarity with the purpose and nature of audit review.

As mentioned earlier, the attitude with which the reviewer approaches his work is of prime importance. His work is peculiar in that there is little or no check on what he accomplishes. It is completely intangible. When he is finished he has no work papers to be cross footed and tied in with other figures to indicate their accuracy. His work is completely mental. He must at all times be fully alert to all the possibilities for deficiencies in the work papers he is reviewing, and must not for a moment let himself adopt the attitude that the questions raised in his mind by his scrutiny of the work papers need not be answered. He must follow up every lead and must not release the papers as acceptable until he is absolutely sure that the verification is complete and satisfactory and that all information required for the report has been included.

As a reviewer reads the individual work papers submitted for his scrutiny he must have in mind the following questions:

1. Is the verification adequate?
   A. Is the program adequate in view of the internal control?
   B. Have the steps in the program been signed for by men who because of the work they have done are in a position to know whether the accounting data verified are reliable or not?

   This includes the study of work assignments to the audit staff members to determine whether related accounts have been assigned in such a way as to avoid omission of important work because each man thought someone else was to do it.
   C. Is each important trial balance item adequately supported by the work paper analyses?
   D. Are the individual work papers complete and self-explanatory in themselves?
   E. Are adjusting entries necessary, correct, and fully explained?
2. Is the information collected in the work papers adequate for preparation of the report?
   A. Are we in a position sufficiently informed as to the reliability of the accounting data to permit us to come to conclusions and to offer an opinion?
   B. Is there sufficient information in the papers to permit the writing of a well-balanced and interesting report?
3. Are any possibilities for additional service to the company under examination suggested by the findings of the audit staff?
   A. Can the internal control be improved, and in what respects?

B. Would changes in accounting procedures or methods provide the company with more useful or more timely reports, or reduce the cost of preparing the present reports?

C. Are suggestions for improvement of the company's business practices in order?

Review Procedure. With these questions in mind the reviewer reads his way through the file of audit work papers, making notes and comments as he goes. When the questions in his mind are not answered satisfactorily he makes notes of additional work to be done and of additional information to be gathered for the report. As he completes his review of work papers which he feels are satisfactory, he initials them, and the verification of those items is then considered complete.

The detailed, step-by-step procedure followed will vary with the preference of the individual reviewer. The following description is therefore presented as an indication of one method of review. Others are certainly possible and in some cases may be more desirable.

First, read the review of the internal control to become acquainted with the operations of the company under examination and also to determine whether all information that should have been collected during the review of internal control is present in the work papers. After gaining an understanding of the degree and extent of internal control, next read the audit program to ascertain its adequacy in view of the information available about the company's operations and activities.

Once this has been completed it is customary to commence the review of detailed work papers. This is generally done with the general ledger trial balance as a basis. With the trial balance before him, the reviewer turns to the work papers supporting the first item in the trial balance. He reads the work sheet carefully, keeping in mind all the questions suggested in this chapter. As a last step, he then compares the final "per audit" amount in the work sheet with the "per audit" figure in the adjusted trial balance column. If all is as he feels it should be, he ticks the amount in the trial balance, initials the work sheet, and turns to the next item.

In this page-by-page review he must be careful to follow out any cross references that he finds. This is necessary not only to make sure that the indexing is adequate but also in order to follow through and make sure that the related papers do actually tie in with and agree with the work sheet he is reviewing. If he permits such cross references to pass with the thought that he will come to them later and pick them up at that time, he is denying himself the opportunity to discover any omis-

sions or inconsistencies. This is particularly important in his review of adjusting entries prepared by the staff auditors. He must scrutinize the entry carefully, satisfy himself that it is required by the facts of the situation and that it is in accordance with sound accounting practice, and then follow it through the related work papers and into the general ledger trial balance to make sure that it has been handled properly by the auditor.

Responsibility of the Field Staff in Review. As indicated, the accountant in charge of the field work on an audit engagement should review the work of his assistants prior to submitting the work papers to his superiors for their review. This is helpful in saving their time and makes for a more complete set of work papers and a better examination. In addition, every man on the audit staff should feel the responsibility of giving his own work as rigorous a review as possible.

Self-review is no substitute for careful, independent review by a superior. Even so it may do a great deal toward making the superior's independent review easier and therefore more effective. If the accountant in charge finds it necessary to concern himself with mechanical details when he reviews the work of his assistants he will find it more difficult to concern himself with the more important matters of adequacy of verification and extent of information gathered. Hence a careful self-review contributes to the overall effectiveness of the examination.

Self-review is important also from the standpoint of making the best impression possible on one's supervisors. In auditing, the relationship between assistants and in-charge accountants is a very close one. The accountant in charge is in a position to know at all times just how well his assistants are doing. For this reason most auditing firms or auditing departments follow a practice of requiring a personnel review of each assistant by the accountant in charge for every engagement. It goes without saying that the more defects the senior accountant finds in the work of his assistants, the less favorable will be his opinions of their work. Self-review thus can make a direct contribution toward one's progress by improving the work which one is doing and by impressing one's immediate superiors with the quality of work being turned out.

Review of the Audit Conclusions. Sometime before leaving the premises of the company under examination it is generally desirable to go over the results of the audit with appropriate members of the company's staff. This may consist of a careful review of the adjusting entries recommended by the auditors or may be merely a general discussion

of the condition of the accounts and records. There are two good reasons for making sure that this has been done. The first is in the nature of another precaution by the auditor against errors on his own part. It is always possible that what appeared to him to be an error, in view of the extent of the information available, is in reality not an error when additional information throwing further light on the accounting is obtained. Hence it is desirable to discuss with those who are responsible for the accounting the nature of any weaknesses or deficiencies to discover whether they support the auditor's contention that certain facts and figures are in error.

The second reason is more in the nature of a public relations effort. Every adjusting entry is in effect a criticism of the company's accounting. This being so, it is a good practice to present them in as mild and friendly a way as possible. An informal discussion with those concerned is a much better way to convince them that errors requiring adjustment have been made than any formal letter can be. There is also the possibility that an entry may not be as clear to the company accountants as it might be. When this is true, informal discussion can easily bring out the reasoning behind the entry. Questions can be answered, and any difficulty of understanding can be readily satisfied.

Sometimes the presence of errors in the accounting data indicate a need for additional investigation or for improvements in the records and procedures. Such possibilities can best be explored through discussions with those most affected.

PROBLEMS—CHAPTER 16

Problem 16–1. You have completed your field work in connection with an annual examination of the financial statements of the Roedgers Company, a small manufacturing concern. This is the first year you have been assigned to this examination. As you are taking leave of the company officials and thanking them for their cooperation, Mr. F. E. Roedgers, the president of the company, asks to see the adjusting entries you propose. What should be your attitude?

Problem 16–2. Throughout the performance of the field work in your examination of the accounts of the Kell Corporation the controller has stopped at your desk almost every day to inquire how the audit is progressing. He is particularly interested in your findings with respect to adjustments affecting the company's net income, and invariably asks what the profit for the year is as you have adjusted it to date. Should you give him this information? If not, how would you answer his questions?

Problem 16–3. You are assigned as a supervisor over the examination of the accounts of the Fillville Water Company which is located in a city about 250 miles from the location of your offices. You review the audit program with the senior accountant in charge of the engagement before he leaves for the job. Although you had hoped to review the work papers in the office of the Fillville Water Company before the audit staff left the engagement, you were unable to do so because of other engagements demanding more time. During your review of the work papers in your own office after the audit staff on the water company engagement had returned and been assigned to other audits, you discover that there is no indication in the work papers that the company's marketable securities in the amount of $86,500 (approximately 20% of the company's current assets) were ever examined by the auditors. The work papers indicate that these securities are kept in a safe deposit box in the local bank. Access to the box requires the presence of two company officials. What would you do with respect to this situation?

Problem 16–4. As supervisor reviewing the work papers for the regular annual examination of the accounts of the Campfield Company you find that the senior in charge of the engagement has not indicated in any way that he has reviewed the work of his subordinates. What should be your assumption? What would you do in view of this?

Problem 16–5. As a junior accountant on your first audit, a large public utility, you have been assigned to verify the property accounts. Performance of the work outlined in the audit program has taken two weeks, and you have accumulated a considerable file of work papers. The accountant in

charge has left you completely to yourself although he has willingly answered such questions as you have asked. State specifically what you should do before turning in your work papers.

Problem 16–6. As chief internal auditor for a large merchandising concern with many branch locations, you have always followed the policy of reviewing the work of your subordinates in their presence. As the company is growing, additional staff auditors are needed but competent personnel is hard to find. To meet this difficulty it has been suggested that staff auditors mail in their reports and work papers and proceed directly to their next assignment rather than report in for review before reassignment. What position would you take on such a suggestion?

Chapter 17

INTERNAL AUDITING

The preceding chapters deal with the general problem of verification of accounting data. The nature of audit evidence, the basic techniques by which such evidence may be accumulated, and the application of those techniques to specific verification problems are discussed. Throughout this discussion, except for the material on internal control in Chapters 5 and 15, the emphasis is apparently on the verification of data rather than on the review of procedures or practices. Two reasons may be given for this apparent emphasis.

First, the basic techniques and their usefulness in accumulating evidence are most readily understood in a study of their application to the verification of data. Second, the same techniques, although perhaps in somewhat different proportions, apply to the examination of procedures and practices as to the examination of data; thus a sound understanding of basic audit techniques is a first prerequisite to any study of auditing. Not until a student has a familiarity with the nature of audit evidence and the means by which it may be obtained in general is he ready to study its application in specific situations. As this textbook is intended to be used in a first course in auditing, it was considered desirable to emphasize those aspects of verification that contribute most to one's understanding of the general field. From this point on, emphasis can be directed at either the verification of data or the review of procedures, as seems most appropriate.

INTERNAL AND INDEPENDENT AUDITING CONTRASTED

Fields of Auditing. Audit examinations are conducted by two different groups: internal auditors and independent auditors. To a student of the subject, the similarities between these two fields far outweigh the differences. That is why it is felt that the general type of discussion in the preceding chapters is most useful; it provides a satisfactory introduction into either field. Practitioners in either field deal with audit evidence, review internal control measures, apply the basic verification techniques in the form of audit procedures, and give their expert opinions

as to the reliability of accounting information and the suitability of accounting practices and procedures.

Although the two fields do have a great deal in common, there are also significant differences that set one apart from the other. For our purposes, these differences may be grouped under four main heads:

1. Extent of independence.
2. Interests served.
3. Relative emphasis in application of the basic techniques.
4. Extent of detail work undertaken.

Each of these will be discussed briefly.

Independence. Internal auditors are employees of the company whose records and procedures they examine. They owe their primary allegiance to the company. Their jobs, their compensation, and their opportunities for advancement are all controlled by the same management that controls and supervises the accounting department under examination. This is not to say that internal auditors have no independence. Independence is as much a state of mind as it is a matter of organizational separation. A high degree of independence in both organization and attitude is entirely possible within an internal auditing department.

If the internal auditing department is organized quite separately from the accounting and treasurer's departments, if the head of the department reports directly to the board of directors or to an officer holding a position at least equivalent to the heads of these two departments, if the employees within the internal auditing department are competent auditors with no fear that a critical report will redound to their disadvantage, examinations performed by such a department may have a substantial degree of independence. They will lack, however, the final degree of independence, that of independence from management. Regardless of the competence and skill of its members and its organizational independence within the company, an internal auditing department cannot, by its very nature, be completely independent from the management whose records it examines.

An independent auditing firm is an organization completely independent of the companies which it examines. As an independent contractor it reserves the right to direct and control its own employees without interference by its client companies. Once the general terms of the agreement to make an examination have been determined, the independent auditor is free to use such methods and to expand or reduce

the amount and kind of work he does at his own discretion. Furthermore, in the report that he presents at the conclusion of his examination, he can express himself without fear of retaliation other than loss of the client. This gives him substantial independence with respect to those whose reports and practices are under examination, a position somewhat less subordinate than that of the internal auditor.

Two additional factors work to increase the extent of the public accountant's independence. First, the codes of ethics of his professional organizations, the requirements of the Securities and Exchange Commission and of similar state commissions which make use of the results of certain of his examinations, and the demands of others such as banks who likewise read and rely on his reports are such that any relaxation in his standards of independence may cost him his professional standing and the loss of his clients. Second, the opinion which he supplies his clients with respect to the reliability of their financial statements is often reproduced by them and passed on to other interested parties. These third parties may rely on the auditor's opinion in making financial decisions with respect to the company examined. Any failure by an independent auditor to perform his examination with due professional care and independence may thus result in losses to unknown third parties. Courts have held that the independent auditor may be held responsible for such financial losses. Each of these factors is an important incentive toward independence.

It should be emphasized that the difference in the independence enjoyed by independent and internal auditors is one of degree only. Internal auditors may attain a considerable amount of independence; they can never reach complete independence. Independent auditors, as their name implies, have that final degree of independence, although they conceivably could sacrifice it by undue subservience to their clients.

Interests Served. Auditors of both groups work to improve the reliability of financial and operating data. In so doing they are of real aid to management and to all interests in business. Yet because of the relative independence of their positions, each group tends to serve a different type of interest. Internal auditors cannot be completely independent of management and therefore their reports and opinions must be of limited usefulness to such outside interests as shareholders and creditors who must have a report not in any way subject to management bias or persuasion. Independent auditors have that final degree of independence; hence their reports and opinions are of more benefit to outsiders.

Internal auditors, as employees, have an advantage over independent auditors. They are on the job the year around, they acquire more familiarity with the company's operations and problems, and therefore may be used by management for a variety of special assignments and examinations. Also, because of the limitations of their reports from the standpoint of outsiders, it follows that their work will be directed more at internal, within-the-company problems than at matters of direct interest to outsiders. Thus in a general way it may be said that internal auditors tend to serve management most directly, whereas independent auditors tend to serve outside interests.

Again this is a matter of degree only. Many small and medium-sized companies have no true internal auditing staff. In such cases they often call on their independent accountants for the type of review, analysis, or investigation that would otherwise be assigned to an internal auditor.

Emphasis in Application of Techniques. As the reports of independent auditors are directed toward outside interests, their examinations tend to emphasize the type of information in which outsiders are interested, namely, the amounts of assets, liabilities, incomes, expenses, and ownership interests. Thus, much of the work of independent auditors is directed at the verification of factual data rather than procedures. Internal auditors, on the other hand, tend to give proportionally more attention to the examination of the operating procedures and practices. To serve management most effectively they make studies of accounting and operating procedures with a view toward discovering any deviations from company-prescribed rules and policies as well as to discover more efficient methods of record keeping and performance.

Internal auditing, therefore, emphasizes the procedural aspects of accounting, although it is also interested in the factual accuracy of the data produced by the accounting department. Independent auditing, on the other hand, gives somewhat less attention to operating and accounting procedures and relatively more to ascertaining the reliability of accounting data.

Extent of Detail Work. Both internal and external auditors make use of tests and samples; neither can make anything like a complete, detailed examination of every transaction except in relatively rare and limited situations. Even so, in most instances it is both possible and customary for an internal auditing staff to do more detail work than would an independent auditor examining the same company. Two reasons may account for this. First, the relative cost of work done by

an independent accountant is generally considerably greater than when done by the company's own employees. Second, to the extent detail work has been performed by a competent and reasonably independent internal audit staff, an independent auditor may reduce the extent of his own examination. From the viewpoint of an independent auditor, a competent and effective internal audit department may be looked on as a feature of internal control. As such it is an indication of reliability in the accounting data produced under its review and the independent auditor should reduce his examination accordingly.

Thus as internal auditing departments become more common, they tend to do more and more detailed work, whereas independent auditors tend to reduce the extent of their own detail work. It may be said quite safely, however, that some detailed work will continue to be required of the independent auditor, at least in the foreseeable future.

INTERNAL AUDITING

As pointed out earlier in this chapter, internal auditing differs from independent auditing chiefly in four respects, the extent of independence enjoyed, the interests served, the relative emphasis in application of the basic audit techniques, and the extent of detail work undertaken. However, the entire story is not told so simply as this. Internal auditing is a rapidly growing field of service and one of considerable importance. As such it requires something more than the brief mention given.

Business activities and business enterprises have increased in size and complexity to the point where it is completely impossible for a single person or even a group of men to keep in touch with all phases of the operations of a large company. This has made accounting and accounting data all the more important. Only through the careful collection and interpretive reporting of selected business facts can management be kept informed as to developments, activities, and the results of the diverse transactions it initiates.

Accounting data are always subject to some error and with the speed and extent of growth of business, accounting data in many concerns can be accepted as reliable only after at least minimum verification procedures have been applied. That is, the importance of accounting information and the decisions based on it are such that it is of primary importance that the information be completely reliable. Temporary lapses in the efficiency of employees, errors resulting from incompetence or lack of understanding, or erroneous data used to cover shortages or defalcations could all result in improper judgments and decisions detri-

mental to the best interests of the company. For that reason it becomes almost essential to verify day by day the data that are supplied to management for decision-making purposes.

It should be apparent that this type of verification cannot be provided completely and economically by independent auditors. An annual examination is not sufficient verification of current operating information. At the same time the cost of verification by independent auditors and the limited number of independent auditors available have made it imperative that some other agency for the verification of operating data on a current basis be developed. Internal audit departments are the answer to this problem. Most large companies now have an internal auditing department of one kind or another. Full recognition of the importance of internal auditing is yet to be realized, but certainly there is a growing awareness of the usefulness of this kind of verification. With it there is also a real growth in the field of internal auditing.

Types of Internal Auditing. Because internal auditing is still a very young field of activity and is one that does not affect public interest as directly as does independent auditing there has been less regulation both from within and without. Consequently it has not developed to the highly organized and standardized state that public or independent auditing has attained. That it must eventually reach such a level seems certain.

At the present stage of development, internal auditing activities may be divided into three groups somewhat as follows:

1. Ordinary accounting work described for purposes of prestige as internal auditing.
2. Actual verification work performed by an independent staff of internal auditors.
3. The review of managerial policies and decisions.

Each of these may require some explanation to differentiate it from the others and to explain more clearly the nature of internal auditing in general.

The title of auditor has come to have considerable prestige attached to it without at the same time having anything like a uniform meaning. It is used to describe the position of many members of internal accounting departments whose work may in one way or another be slightly different from that of other members of the department without at the same time having anything to do with verification or review. For example, the assistant chief accountant may be called the company auditor to

differentiate his work from that of the rest of the accounting department employees. Also, there is always a certain amount of work that must be done during the ordinary processes of accounting that is similar to the verification we think of as real auditing. For example, someone should be assigned to review suppliers' invoices before they are approved for payment to determine whether they represent legitimate company purchases, are reasonable and proper in every way, and should be paid with company funds. The person assigned to such a task is frequently described as an internal auditor. Again, various special assignments within the accounting department such as the analysis of standard cost variance accounts, the maintenance of insurance records, or the keeping of fixed property ledgers, are sometimes considered to be sufficiently different from the ordinary run of accounting work to justify calling the responsible employee an auditor.

From the preceding chapters of this book it should be apparent that the essence of auditing is the independent verification of previously performed accounting work. Original accounting, no matter what the degree of difficulty or importance, is not auditing. Use of the term to describe the work of members of the accounting department is unfortunate and improper. Auditing is by nature the review of the work of others, not the original performance of that work. Perhaps it is inevitable that the term should have sufficient prestige to make it a coveted one. On the other hand, improperly describing the work of an accounting department employee does not make it any the less an accounting function. We can only conclude that to apply the term internal auditing to accounting department functions is an error in the use of the term. Such work is not true auditing at all.

Many concerns do have an internal department separate from the accounting department that does review the operations not only of the accounting department but of other divisions of the business as well. Such a department, if adequately staffed and given sufficient independence of action, may appropriately be called an internal auditing department. Its work compares favorably with that done by independent auditors although, as described earlier, there is some difference in point of view and emphasis.

Finally, there is a recent tendency for qualified internal auditors to undertake another type of review that is somewhat beyond verification as we ordinarily think of it. Internal auditors tend to combine the intimate knowledge of a company's operations obtained through constant study and work within the company with the independence and disinterested attitude of an independent auditor. Thus they are in a favorable

position to pass judgment on policies and practices of a general business nature as well as an accounting nature. Matters such as office procedure and accounting organization are of course within their cognizance. In addition they may go well beyond that area of policy and procedure. They may be able to make suggestions as to better methods of storing and handling raw materials and finished product. They may be able to criticize helpfully the company's investment or insurance program. They may have useful ideas as to employees' pay schedules and profit-sharing arrangements.

This is not to say that every member of an internal audit staff is immediately an expert on all phases of the company's activities. Yet as well-qualified employees gain experience within the company and at the same time develop their abilities to review effectively, they should become competent business men as well as audit technicians. As they do so they should not hesitate to make their ideas useful. Managerial review at all levels is of importance in large-scale business enterprise if costly mistakes are to be avoided and errors once made are not to be repeated. Perhaps there is no type of work within a company that is better designed to qualify an alert employee for this type of review than that performed by a true internal audit department.

Requirements of an Internal Audit Department. To be effective, an internal audit department must have competent personnel, must have a staff adequate to deal with the verification problems it faces, and must have sufficient independence to perform its review function effectively. To be competent members of an internal auditing staff, employees must, of course, have a thorough understanding of accounting and audit techniques and procedures. In addition, they must have a sufficient background of education and experience to fit their specialized technical training into the general business picture. More important perhaps than any other characteristic of the individual internal auditor is that of the open, inquiring mind described in Chapter 1 as the auditing attitude. Knowledge without the desire to use it effectively is of little benefit. Members of an internal audit staff need the same incentive to pursue questionable information and practices to a satisfactory conclusion as do members of the staffs of independent audit firms.

To this end provision must be made for staff training to impress on new men their duties and responsibilities. Thorough review procedures and as much variety of experience as possible should be included. Given the desire, an internal auditor can learn at least as much about the company for which he works and whose records and procedures he examines

as can any member of its accounting or other departments. This is an advantage that an independent accountant rarely if ever enjoys.

Adequate staff for the task at hand is, of course, an essential. The review of procedures and practices and the verification of data that should be carried out as part of a regular, recurring program cannot be accomplished as they should unless the internal audit department has sufficient personnel to do the work.

The matter of independence is always a difficult one for an internal auditing department. It will of necessity report to someone within the company organization and therefore lacks the final degree of independence possessed by public accountants. On the other hand, if it reports to an appropriate level of authority within the enterprise it can well have sufficient independence to make itself effective.

It should be recognized that independence here is a twofold concept. First, the internal audit staff must have sufficient independence of activity to select its own verification tasks and the manner in which that verification is to be performed. This is not to say that it must be able to go anywhere in the company at any time for any purpose. It may well be requested to concentrate its efforts in given areas, particularly if it is so understaffed as to be unable to make satisfactory company-wide verification. It must not, however, be forbidden to extend its verification to any specified activities or departments. Also, it must have freedom in the design and performance of its work program. General approval of such a program by a higher authority may be accepted, but there must be absolutely no interference with its verification activities by members of the departments or activities under examination. To the extent possible, the internal auditing staff must be viewed as an independent operating unit within the company. It is available for such assignments as appear necessary but must have complete freedom as to the method of performing its examinations and other assignments.

The second phase of independence has to do with the authority to which the internal audit staff reports. Theoretically it should report to no lesser authority than the board of directors. In that way it is freed from interference or duress by any company employees or officials. For reasons of desirable organizational procedure this situation is seldom found. In most cases an internal audit department must report to someone on a lesser level than the board of directors.

As internal organizations vary so much, one from another, it is not practicable to state categorically the officials within a company to which an internal audit staff might or might not report and still enjoy satisfac-

tory independence. A better way of describing its relationship with the rest of the company's organization and personnel might be to state that:

1. An internal audit staff must report directly to and be responsible to no lower level of authority than that which is responsible for the work under examination.
2. To the extent that an officer or employee has a direct interest in an activity or function, he should be disqualified as an authority qualified to accept or reject the reports of the independent audit staff with respect to that activity or function.

As an example of the distinctions that are implied in the preceding statements we may assume a company organization in which a controller is responsible for all company records and occupies a position on the organization chart on a par with the treasurer. He is a superior to both the head of the accounting department and to the chief internal auditor. In this case, if the internal audit staff is composed independently of the accounting department, it is in a position to report effectively on both the treasurer's department and the accounting department. If the controller were in a position inferior to the treasurer, any audit of the treasurer's department might lack independence. Likewise, if the chief internal auditor were considered a member of the accounting department or if the controller to whom the chief auditor reported took an active interest in the performance of the accounting duties, the internal audit staff would, to that extent at least, lack desirable independence.

A third phase of independence might be added, although it seems so apparent as to be understood without specific mention. The internal audit staff must have reasonable independence from other duties. It is not unusual to assign to the internal audit staff the responsibility for certain original accounting work or similar duties. If these become a major part of their activities, they may so interfere with verification efforts as to prevent an effective exercise of the review function. When this occurs, the internal audit staff ceases to function as such and becomes but another part of the accounting department.

Methods of Operation. Stated in general terms, the work of an internal audit staff is very similar to that of an independent audit staff. Both make extensive use of the basic audit techniques described in the earlier chapters of this book. Both concern themselves with internal control and make recommendations for its improvement. Both alter the nature and extent of their work in accordance with their findings as to the scope and effectiveness of internal controls in existence.

Beyond this, little can be said in terms of specifics. Situations vary severely, and internal auditors must vary their procedures accordingly. The internal auditor for a steel company consisting of a single plant has a far different problem than an internal auditor for a chain of small loan companies. There is always a definite limitation to the amount of verification that can be attempted; thus the internal auditor has a problem similar to that of the independent auditor of attempting to work out the most useful program of verification within the bounds of his time and cost.

Normally this can be solved most effectively by developing a long-range audit program. Such a program must take into account the minimum verification work such as bank reconciliations, tests of payrolls, and tests of vendors' invoices that must be done periodically and currently. Then it must also give consideration to any peculiarities of the business that require special attention. Finally, it must include those verification steps that either need not be performed on a regularly recurring basis or which are best done only occasionally or on a surprise basis. Preparation of such a program as described here may sound a good deal easier than it actually is. Only by constantly modifying such a program over a long period of time can there be any assurance that the best possible schedule of internal audit has been obtained. Changes in the company's methods of doing business, changes in government regulations applicable to the concern, variations in emphasis on one activity or function as compared with another, and other like matters will constantly call for review and revision of the audit program.

Included within the audit program must be a generous allowance for the review of company procedures as they operate. A large part of internal audit work should be directed at the prevention rather than the correction of errors in the data reported by the accounting department. This can be accomplished most effectively by reviewing internal control procedures for any deviations from established practices. Practices followed incorrectly are most likely to lead to erroneous results. Constant examination of procedures as they are carried out will discover any variations from required practice and thus help to prevent errors in the results.

With careful planning, the review of operating procedures can be made in such a way as not to interfere with the accounting processes of the company any more than absolutely necessary. In some cases it may be possible for members of the accounting staff and the internal audit staff to work in close cooperation and at the same time maintain their independence of one another. To the extent that this facilitates accomplish-

ment of the accounting function and permits an effective verification it should be encouraged.

Special Services of Internal Auditing. One of the characteristics of modern business activity is the number of government and other regulations under which it operates. These requirements range from government decrees having the force of law through contractual agreements contained in bond indentures and insurance policies to completely voluntary rules established by management itself. The various members of the operating and service departments of the enterprise, other than internal auditing, are expected to meet these requirements. If they fail to do so it is possible the company will incur serious consequences of one kind or another. For this reason care must be taken to assure the company that it is complying with all pertinent requirements, self-imposed as well as those prescribed by outside authorities.

The internal audit staff is well situated to cover this matter in its review of the activities and records of the various departments of the company. One of its most important services to the enterprise is this matter of assuring that adequate compliance with all pertinent requirements has been obtained. This places a considerable burden on the internal audit staff but a burden that is entirely compatible with its other duties and with the nature of the work it is expected to do.

In the establishment of a long-range audit program, considerable attention to the determination of compliance with pertinent requirements is called for. As additional developments in government activities and in business practices bring new requirements, it becomes a responsibility of the internal audit department to ascertain their nature and to report any failures to so comply.

Cooperation with the Independent Auditor. In as much as the work of the internal audit staff and that of the independent auditors are directed toward the same end, the production of reliable accounting data and the maintenance of adequate internal control, every effort should be made both to avoid duplication and to obtain better coverage of all possibilities through a sound integration of activities.

The existence of an internal audit staff does not make an annual examination by independent accountants any less desirable. In the same way, an annual examination by independent auditors is no substitute for the day-by-day work of an internal audit staff. Each has its necessary place, and neither can be fully supplanted by the other.

From the standpoint of the independent auditor, an efficient internal audit department may be looked on as a valuable contribution to internal control. As such it encourages him to reduce the extent of his detail audit tests and to place greater reliance in general on the company's accounting records and procedures. Beyond this, however, much more can be done through actual cooperative planning.

In reviewing the internal control before preparing his examination program, the independent auditor will want to review the reports and work programs of the internal audit staff for the year to determine to what extent they represent verification work on which he can rely and which he will have no need to duplicate. This might almost be called "negative cooperation," the mere avoidance of duplication. In addition, if the independent auditor knows of his appointment early in the year, it is possible for the chief internal auditor and the independent auditor in charge of the assignment to work out a program of work by the internal audit staff that will greatly reduce the year-end work of the independent auditor.

This will range all the way from the preparation of trial balances and various account analyses to the performance of complete audits at branch offices. It is frequently impossible for an independent auditor to visit and examine all the branch establishments of a client company every year. With the aid of a dependable and independent internal audit staff he can work out a schedule so that every office is visited at least once each year for a thorough examination by either the internal staff or the independent accountants. Sometimes the program to be followed is developed by the internal auditor in consultation with the independent accountant; often representatives from the two staffs might team up to examine a given location or division.

Just as there is much yet to be done in the development of internal auditing, so there is much yet to be done in working out more complete cooperation between independent and internal auditors.

PROBLEMS—CHAPTER 17

Problem 17–1. You are employed as internal auditor by the Green Oil Company which operates a chain of automobile service stations. You are its first internal auditor, and the company president states to you that the purpose in employing you is to put a stop to the several shortages of gasoline, tires, and other items that have occurred at their various locations. He asks you to submit a general outline of the procedures you intend to follow. Prepare such a program.

Problem 17–2. Prepare an audit program to be followed by the members of the internal audit department of a state-wide public utility having branch offices in approximately 30 towns and collection points at approximately 40 more. The branch offices keep complete double-entry records, collect and disburse cash, and carry an inventory of construction materials. The collection points merely collect cash from customers and forward it to the home office. All billing is done by the home office. Each month the collection points receive a list of customers' balances to be collected. This and their daily report of cash collected are the only records kept.

Problem 17–3. The Henderson Manufacturing Company has an employees' cafeteria that serves approximately 1,500 meals a day plus coffee and soft drinks during rest periods. The cafeteria is operated by an outside catering firm, which is guaranteed a profit of 20% of its food and labor costs by the company. Any deficiency in the catering company's profits are paid directly by the Henderson Manufacturing Company. As the chief internal auditor for the Henderson company, prepare a program for your assistant to follow in verifying the catering company's semiannual request for payment from the company.

Problem 17–4. The Nation-Wide Groceries is a chain of large supermarkets. It has a team of internal auditors constantly engaged in examining individual supermarkets. Centralized purchasing is handled by the home office; shipments to the markets are billed at selling prices by the home office. All sales are for cash. Cash receipts are deposited daily in a local bank which is instructed to permit withdrawal only by home office checks. The manager of each market has a bank account maintained on an imprest basis for expenditures that must be handled locally. All payrolls are paid from the home office. As internal auditor, what would make up the most important part of your work in examining individual supermarkets? Explain fully.

Problem 17–5. As chief internal auditor for a small manufacturing company you are asked by the controller to cooperate as completely as possible

with the independent accountants in order to facilitate their examination and effect any economies possible. What would you suggest?

Problem 17–6. Prepare an audit program for use by an internal audit staff in the examination of branch offices of a small loan company.

Problem 17–7. Payrolls for the Kelly Construction Company are prepared by timekeepers in the field and are then forwarded to the home office for preparation of checks. As construction workers dislike waiting for their pay, the home office prepares the checks and sends them back to the timekeepers for distribution as rapidly as possible. As many as 1,500 men at 30 different locations may be working at one time. The general manager of the company feels that payroll disbursements have increased without an increase in the amount of work done, but he has neither the time nor the training to discover exactly what is wrong. He instructs you to "drop out of the accounting department for six months and look into this thing." What procedure would you follow?

Problem 17–8. You are the internal auditor for a company that has a considerable amount of scrap metal as a result of its manufacturing process. Outline a system of controls over sales of this scrap material that will prevent employees from disposing of it to their personal advantage.

Problem 17–9. You are employed as its first internal auditor by the Wright Amusement Company which operates a chain of 27 moving-picture theaters in approximately half of a midwestern state. The company president tells you that so far as he knows there is not a thing wrong with the company at present, and he wants you to make sure that no trouble arises. What would be your approach to such an assignment?

Chapter 18

INDEPENDENT AUDITING

As described in the preceding chapter, public accountants are independent experts who are available to serve their clients in a professional capacity with respect to the examination of accounting data. In addition to making audit examinations, they also serve in the preparation and review of tax returns, on engagements involving systems development or revision, and in other matters relating to accounting. As our interest here is in the verification of accounting data, this discussion will restrict itself to those phases of an independent accountant's work related to auditing.

Staff Organization. Independent accounting firms, with rare exceptions, are either partnerships or sole proprietorships. If the organization is that of a partnership, it is common practice to select one member as the "managing" or "executive" partner. With the assistance of a committee, he assumes final responsibility for firm policy and operations.

Each client is assigned to one or another of the partners who, subject only to his compliance with firm policies, is completely responsible for adequately serving that client. This is not to say that each partner carries on his practice in complete independence of the others. Mutual respect and cooperation are essential if a partnership is to be successful. Partners confer with one another frequently, share experiences and problems, and feel completely free to call on one another for advice. It is necessary, however, that some one person in the organization take final responsibility for satisfying each client's requests, a responsibility that can be discharged only at the partnership level. Each partner, therefore, must be not only a competent accountant and auditor, he must also have some of the attributes of a customer's man. He must be able to meet and deal with a variety of people and their accounting problems.

Immediately below the partners in the scheme of organization is a group known variously as "supervisors," "managers," "principals," or by some similar term. It is from this group that new partners are commonly drawn. These men have come up "through the ranks," have demonstrated their technical auditing abilities, and occupy an important

junior executive type of position. They take charge of a group of clients under a partner's supervision. As they have a smaller number of clients assigned to them they can become more familiar with the details of their clients' organizations and the nature of their accounting problems. With competent supervisors to help him, a partner can care for a great many more clients than he could if he had to achieve close familiarity with each. Supervisors can solve most of the problems which arise in the course of an audit engagement and are responsible for the effective performance of the engagement. They are free to call on the partner for advice and help as they feel necessary, and are expected to inform him of any developments or other matters that might affect the firm's relations with the client.

Below the supervisory group is found another group of staff accountants best described by the somewhat awkward term "in-charge accountants," although the term "senior" is also common. These are the accountants who take direct responsibility for performance of audit field work. An in-charge accountant is normally assigned to one engagement at a time. He is responsible to his supervisor for the development and performance of an acceptable audit program. Any assistants work under his immediate control; he assigns them various components of the program and reviews their work to make sure that it is satisfactory. His training and experience must be such that he can meet and solve day-by-day problems on his own initiative because frequently he may not see his supervisor from the time the audit program is approved until the field examination has been completed. Most important, however, he must know when he is in difficulty; he must recognize serious situations and problems that are beyond his abilities or authority. These he must bring to the immediate attention of his supervisor so that the supervisor's greater experience and more mature judgment may be brought to bear on the problem.

It is safe to say that the backbone of a good audit staff is found in the in-charge group. Not only do these men direct the field work, supervise, and give on-the-job training to their assistants, but it is upon them that the final responsibility for recognizing any serious problems rests. In view of the fact that a partnership or proprietorship has unlimited liability and at the same time may be held responsible to unknown third parties if the examination does not meet professional standards, the position of in-charge accountant is of considerable importance.

Assistants, or "junior accountants" as they are often called, comprise the largest single group in the organization; hence they do the bulk of the field work. They work directly under the in-charge accountant sub-

ject to his instructions. Their responsibility is for the adequate performance of their assigned tasks and also to bring to the attention of the in-charge accountant any errors, variations from the client's established procedures, or deviations from accepted accounting practices, and, of course, any other matters that arouse their suspicions.

A wide range is found in the extent of talent and experience among the members of this group. It includes the most recent additions to the audit staff who may have no experience whatever as well as men who have had sufficient experience to qualify as in-charge accountants on small engagements. This group is sometimes divided into "junior" accountants and "semi-senior" accountants, the latter term applying to those who are bordering on the "senior" accountant or in-charge accountant rating.

It will be seen from this brief discussion of divisions within the staff of a public accounting firm that the various groups tend to merge one with another rather than to be clearly separated. For example, it is sometimes difficult to state precisely when a man passes from the advanced assistant or semi-senior classification into that of the in-charge accountant. He may act as the accountant in charge on small engagements while still an assistant; on the other hand, after reaching senior status he may act as second man on an extremely large job. Such matters as the amount of work to be spread over the available staff, the difficulty of the specific assignment, and the degree of supervision all affect the selection of personnel for given examinations.

Another point worthy of mention is that close cooperation of each group with the others is required. On any audit engagement, some members of each group participate. The work of each is important; each one makes a contribution to successful completion of the examination. Each must take his own work and that of the others seriously. Negligence or listlessness on the part of any member of the audit team may nullify the efforts of all.

Review Procedures. The review procedures set up by a public accounting firm in order to maintain professional standards in its examinations and reports follow the organizational lines described in the preceding section. On the job, the accountant in charge reviews the work of each of his assistants, as described in Chapter 16. The supervisor generally reviews all the work papers, including those prepared by the in-charge accountant, while the audit staff works on the report and before they leave the field. In the office, the partner may review the report before it is typed and, depending on the extent of responsibility carried

by the supervisor, may also look over the work papers. After the report has been typed and is ready to be mailed to the client, the partner again looks it over and signs it, generally in the name of the firm.

In addition to the review of the work papers and report for completeness and propriety, an additional review of the report for arithmetical accuracy, internal consistency, and possibly for grammar and construction is performed by a "report" or "comparing and proving" department.

A cardinal point of review procedure is that the work of each person must be reviewed at least once by a superior. This apparently is not true for the work of the partners, but as they do no original work on the engagement their work does not need review in the same sense as the work of others. Furthermore, they assume ultimate responsibility for the work and therefore have no superiors to review them.

Report Writing. It has been said that the best time to write an audit report is while the examination is in progress. The suggestion is that, as matters worthy of comment in the report are found, they should be written up in such a way that they may later be included in the report with a minimum of rewriting. If this practice is followed, there is much less opportunity for omitting significant material from the report, and the time required for writing the report is reduced.

The report is drafted by the in-charge accountant subject to general instructions from the supervisor. It is then reviewed and checked to the work papers by the supervisor before he approves it for final review by the partner. (The content and style of reports are considered in Chapter 19.)

Audit Standards. Individual audit engagements differ in so many and in such important respects that it is impracticable and unreasonable to attempt to establish a uniform audit program to be applied in every engagement. It is almost as difficult to set forth a list of basic or minimum procedures to be followed in all cases. This makes the problem of maintaining a high professional level of work throughout all the many different firms in the country an arduous one. As an aid to establishing and maintaining a high standard for the profession of independent auditing, the American Institute of Accountants, through one of its committees, has developed and published a series of "auditing standards." These summarize in a general way the requirements that an audit examination must meet if it is to be considered a satisfactory, professional effort. Some of these standards refer to the examination in general,

others are directed at the field work and at the audit report. In general they are self-explanatory.

General standards. 1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.

3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

Standards of field work. 1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

Standards of reporting. 1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an over-all opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking.[1]

Although not stated in precise terms, these generally accepted auditing standards provide the most specific measure currently available for determining whether or not an audit examination and report meet professional requirements.

Regulation of the Profession. Public accounting, which includes the field of independent auditing, is regulated or controlled in two different ways. First, entrance into the profession is governed by state laws which in some cases proceed to establish codes of ethical conduct by which practitioners must abide or lose their license to practice. Second, organizations of professional accountants have adopted codes of

[1] "Generally Accepted Auditing Standards—Their Significance and Scope," American Institute of Accountants, New York, 1954.

ethical conduct with which their members must comply or lose the recognition of their fellow practitioners.

License to Practice. The laws of the various states differ in detail as to who may and who may not enter into the practice of public accounting. The degree of certified public accountant is a prerequisite for practice in most states and as such is of importance in the regulation of the profession. Requirements to be met before the coveted degree is granted include

1. Certain requisites of age, education, citizenship, and the like. These vary somewhat from state to state.
2. Successful completion of a comprehensive examination covering accounting theory and practice, auditing, and business law. A uniform examination prepared by the American Institute of Accountants is now used in all states and the District of Columbia.
3. A period of experience on the staff of a licensed and practicing public accountant. The required period varies, generally, from one to three years, although in some states no experience is required and in others as much as six years' experience is necessary.

These requirements insure that anyone licensed to practice public accounting under his own name possesses certain qualifications that the administering agencies feel are necessary for protection of the public good. They are also helpful in holding the standards of the profession at a high level.

Professional Organizations. Several voluntary organizations of accountants exist. Of these, the American Institute of Accountants, the national organization of practicing certified public accountants, is probably the most important to an auditor. It works closely with state societies of certified public accountants which are active organizations in almost every state. The activities of the Institute and the closely allied state societies in furthering the advancement of the profession are too extensive for discussion here. One activity, that of helping to regulate the profession, is of interest because of its importance in independent auditing.

Through committees set up to deal with special areas of interest such as auditing procedure and professional ethics, the Institute takes an active part in establishing and improving practices and procedures followed by independent auditors. The Institute has also developed a code of ethics

(presented in the following section) to which its members are required to adhere. Failure to abide by these rules will result in charges being brought against the member before a committee of the organization. If, after a full and fair hearing, it is found by the committee that the member is guilty of unprofessional conduct he may be reprimanded or, if the misconduct is serious, his membership may be forfeited. As membership in the accepted organizations is something of a mark of quality in any profession, loss of one's membership in the American Institute of Accountants for disciplinary reasons is a serious blow to a public accountant's prestige, pride, and professional standing.

Professional Ethics. Among the requirements of any profession is a well-established and generally accepted code of ethical conduct.[1] The American Institute of Accountants has promulgated such a code. It has been accepted by the membership of the Institute and used as a model by many state societies in the development of their own codes of behavior.

The purpose of a professional code of ethics is, first of all, to protect the public by requiring practitioners to meet certain standards in their professional activities and to refrain from improper activities. Second, it is to protect members of the profession in their relations with one another from the reckless or harmful activities of unscrupulous or thoughtless competitors. The rule against advertising, for example, is sometimes criticized as working in favor of the large established firm with its reputation already made and against the beginning accountant who is unknown beyond a small circle of personal acquaintances. Accountants have recognized that advertising is detrimental to the profession because publicly claiming excellence in what are essentially personal abilities is not calculated to inspire trust. There is the further point that advertising by a small practitioner might force his larger "competitor" to indulge in the same practice. In competitive advertising, the larger firm with greater resources would have a decided advantage; hence this rule actually works in favor of the small practitioner.

Each of the rules in the following list is subject to the same test, and each, it will be found, meets the requirements. Every one is intended either to protect society directly by holding accountants to high standards or indirectly by preventing practitioners from spending themselves in activities which are essentially unfair competition.

[1] For an excellent discussion of the need for integrity among accountants, see "The Accountant and His Conscience" by Professor H. T. Scovill, *The Illinois Certified Public Accountant*, March, 1952.

RULES OF PROFESSIONAL CONDUCT

American Institute of Accountants

As Revised December 19, 1950

(These rules of conduct supplement the disciplinary clauses of the by-laws.)

1. A firm or partnership, all the individual members of which are members of the Institute, may describe itself as "Members of the American Institute of Accountants," but a firm or partnership, not all the individual members of which are members of the Institute, or an individual practicing under a style denoting a partnership when in fact there be no partner or partners, or a corporation, or an individual or individuals practicing under a style denoting a corporate organization shall not use the designation "Members of the American Institute of Accountants."

2. A member shall not allow any person to practice in his name who is not in partnership with him or in his employ.

3. Commissions, brokerage, or other participation in the fees or profits of professional work shall not be allowed directly or indirectly to the laity by a member.

Commissions, brokerage, or other participation in the fees, charges, or profits of work recommended or turned over to the laity as incident to services for clients shall not be accepted directly or indirectly by a member.

4. A member shall not engage in any business or occupation conjointly with that of a public accountant, which is incompatible or inconsistent therewith.

5. In expressing an opinion on representations in financial statements which he has examined, a member may be held guilty of an act discreditable to the profession if

(*a*) he fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading; or

(*b*) he fails to report any material misstatement known to him to appear in the financial statement; or

(*c*) he is materially negligent in the conduct of his examination or in making his report thereon; or

(*d*) he fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion; or

(*e*) he fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances.

6. A member shall not sign a report purporting to express his opinion as the result of examination of financial statements unless they have been examined by him, a member or an employee of his firm, a member

of the Institute, a member of a similar association in a foreign country, or a certified public accountant of a state or territory of the United States or the District of Columbia.

7. A member shall not directly or indirectly solicit clients by circulars or advertisements, nor by personal communication or interview, not warranted by existing personal relations, and he shall not encroach upon the practice of another public accountant. A member may furnish service to those who request it.

8. Direct or indirect offer of employment shall not be made by a member to an employee of another public accountant without first informing such accountant. This rule shall not be construed so as to inhibit negotiations with anyone who of his own initiative or in response to public advertisement shall apply to a member for employment.

9. Professional service shall not be rendered or offered for a fee which shall be contingent upon the findings or results of such service. This rule does not apply to cases involving federal, state, or other taxes, in which the findings are those of the tax authorities and not those of the accountant. Fees to be fixed by courts or other public authorities, which are therefore of an indeterminate amount at the time when an engagement is undertaken, are not regarded as contingent fees within the meaning of this rule.

10. A member shall not advertise his professional attainments or services:

(*a*) The publication of what is technically known as a card is restricted to an announcement of the name, title (member of American Institute of Accountants, CPA, or other professional affiliation or designation), class or service, and address of the person or firm, issued in connection with the announcement of change of address or personnel of firm, and shall not exceed two columns in width and three inches in depth if appearing in a newspaper, and not exceed one-quarter of a page if appearing in a magazine or similar publication.

(*b*) A paid listing in a directory is restricted to the name, title, class of service, address and telephone number of the person or firm, and it shall not appear in bold type, box, or other form of display, or in a style which differentiates it from other listings in the same directory.

11. A member shall not be an officer, director, stockholder, representative, or agent of any corporation engaged in the practice of public accounting in any state or territory of the United States or the District of Columbia.

12. A member shall not permit his name to be used in conjunction with an estimate of earnings contingent upon future transactions in a manner which may lead to the belief that the member vouches for the accuracy of the forecast.

13. A member shall not express his opinion on financial statements of any enterprise financed in whole or in part by public distribution of securities, if he owns or is committed to acquire a financial interest in the enterprise which is substantial either in relation to its capital or to his own personal fortune, or if a member of his immediate family owns or is committed to acquire a substantial interest in the enterprise. A

member shall not express his opinion on financial statements which are used as a basis of credit if he owns or is committed to acquire a financial interest in the enterprise which is substantial either in relation to its capital or to his own personal fortune, or if a member of his immediate family owns or is committed to acquire a substantial interest in the enterprise, unless in his report he discloses such interest.

14. A member shall not make a competitive bid for professional engagements in any state, territory, or the District of Columbia, if such a bid would constitute a violation of any rule of the recognized society of certified public accountants or the official board of accountancy in that state, territory, or District.

15. A member of the American Institute of Accountants engaged in an occupation in which he renders services of a type commonly rendered by public accountants, must observe the by-laws and rules of professional conduct of the Institute in the conduct of that occupation.

16. A member shall not violate the confidential relationship between himself and his client.

Legal Rights and Responsibilities. As members of a skilled prc fession, independent auditors have certain rights and responsibilities i connection with the work they undertake for others. In as much a public accounting is still a relatively new field of professional activit the rights and responsibilities of its practitioners have not yet been com pletely and definitely established. Hence it is difficult to make cate gorical statements as to the legal responsibilities incurred by accountant when reliance is placed on their opinions by clients and third partie: However, a few general statements can be made as a guide to an undei standing of the manner in which an independent auditor is expected t discharge his duties.

It should be emphasized that these rights and responsibilities grow ot of the professional status of the independent auditor. As a member c a skilled profession he is expected to be competent to perform the wor which he represents himself as able to do. Because of the peculiar natui of his work, which includes the expert examination and expression c an informed opinion on the financial statements of others, he is expecte to be completely independent in the planning and performance of h work. Because his work may provide a basis for the actions of othei in advancing credit or investing in securities he is expected to exercis appropriate care and diligence in arriving at and expressing his opinioi During the course of his work he inevitably has access to considerab information pertaining to his client's business, some of which may b of a highly secret nature; such information he is expected to keep con pletely confidential.

On the other hand, it is accepted that an auditor is not in any way a guarantor of the statements to which he adds his opinion or certificate. The financial statements are considered to be the representations of the company under examination; the independent accountant merely expresses his own expert and informed opinion as to the reliability of the information presented in the financial statements. Neither is the independent auditor responsible for the detection of all fraud which may be present. It is an accepted fact that an independent auditor bases his opinion on tests and samples. In many cases this will result in the discovery of defalcations or embezzlements but in other instances it may not. An independent auditor is expected to make and is held accountable for an examination in accordance with generally accepted audit standards. If such an examination would disclose the irregularities in question he should discover them. Beyond this he is not responsible for the discovery of the acts of dishonest employees or officers.

Responsibility to Clients. The performance of an audit examination must be based on an agreement between the auditor and his client. Whether stated specifically in written terms or only very generally in an oral understanding, the accountant is bound by the terms of this contract. It is an extremely unwise practice to enter into anything as important as an audit engagement without a specific statement as to the work which the auditor undertakes to perform. Unless the auditor specifies with reasonable accuracy the nature of the examination he undertakes to make, the client may later claim, to the disadvantage of the auditor, that a more comprehensive or more detailed investigation was intended.

In the performance of the examination the auditor is, of course, expected to exercise the skill and competence of a professional person. In addition he must maintain the confidential nature of the information entrusted to him. To the extent that he fails to perform in accordance with the terms of his contract with the client, fails to exercise due care and ability, or fails to keep confidential the information to which he has access, he may become legally responsible to the client for breach of contract. The damages in such circumstances will be the loss suffered and proved by the client to arise from the auditor's failure to perform. The loss may be only the amount of the fees charged by the auditor or may be a much larger sum.

Responsibility to Third Parties. The independent auditor's contract is usually with the company under examination. Yet the nature of his

work is such that he may become responsible to others not parties to tl contract. His opinion as to the reliability of the financial statements desired by the client both because it is good assurance that he himse can rely on the information contained therein and because the financi statements will be accepted by banks, various regulatory agencies, stoc holders, and others as being dependable and properly prepared. Wh these outside interests read and rely on the independent auditor's opinio a development which the auditor should recognize as a possibility wh he submits his report to the client, they place certain responsibilities c him. In general, these are for the competent and careful performan of his examination and for the disclosure of any material informatic obtained during the examination that might influence readers of tl statements to act differently than they would act based only on the stat ments as presented.

It has been established by means of legal decisions that under tl common law an accountant is responsible to third parties for damag suffered by them in innocent reliance on the auditor's opinion if th opinion is fraudulent. Fraud may be present if an auditor expresses a opinion when he does not have a sincere and honest belief in that opinic or if his examination has been so grossly negligent as to give him i sufficient grounds for expressing a professional opinion. Thus, if a independent auditor has failed to make a satisfactory examination, oı in accordance with generally accepted audit standards, he may be he accountable for damages resulting to third parties from their reliance c his opinion whether he knew that such reliance was to be so placed c his opinion or not. Thus he has a substantial responsibility to an u known number of third parties.

If the auditor has definite knowledge that certain third parties w rely on his opinion, such as in an audit examination prepared speci cally to support a request for bank credit, his responsibility may becon somewhat greater. Here he may be responsible for negligence as we as fraud.

Under the terms of the Federal Securities Act of 1933 and the Feder Securities Exchange Act of 1934, the responsibility of the independe auditor to third parties who rely on his opinion attached to financi statements has been increased substantially. Under the terms of the acts an issuer of securities must file a "registration statement" with tl Securities and Exchange Commission prior to the sale of securities the public through the mails or in interstate commerce. Included with the registration statement are the financial statements of the issuii

company together with an independent auditor's opinion as to their reliability. Any person acquiring securities described in the registration statement, whether or not he is a client of the auditor, may sue the auditor for damages resulting from an alleged false statement or misleading omission in the financial statements. It is not necessary to prove that the auditors were negligent or fraudulent in the expression of their opinion. The plaintiff does not even have to prove that he relied on the statement or that the loss he suffered was a direct result of the falsity or misleading character of the financial statements. To defend himself against such a claim the auditor must establish the absence of negligence or fraud in his work by proving that his examination was satisfactory and that he did believe in his opinion as expressed. He may also prove as defense that the plaintiff's loss resulted from causes other than any false statements or omissions in the financial statements.

Obviously this places an extremely heavy burden on practicing auditors. Their only real safeguard is in the careful and skillful performance of their work together with the development of professional standards which are reasonable and generally accepted both within the ranks of their own profession and by those who rely on their opinions.

Rights of Independent Auditors. One of the obligations of an independent auditor is to maintain suitable independence in the performance of his work. This may also be viewed as one of his important rights. As an independent contractor he has the privilege as well as the duty of determining the extent of his examination and the methods to be followed. If the client infringes on this right by limiting the extent of the auditor's work or by refusing him access to certain information, the auditor need only report such facts in his opinion and thereby limit his responsibility in that respect. In other cases he might refuse to give an opinion because the situation was such that an opinion might be misleading to those who read it.

Another important right of independent auditors has to do with the ownership of audit work papers. It has been clearly established that the work papers prepared during the course of an audit examination become the property of the auditor. This is almost an essential because the work papers are the best evidence an auditor has with respect to the extent of his examination and its performance in accordance with generally accepted audit standards. However, the auditor's ownership of work papers is not without limitation. The confidential nature of an auditor's relationship to his client requires that he protect the information

in audit work papers from any improper use that might run counter to the best interests of the client. He is not free to dispose of them in any way he chooses. He may keep them for his own purposes; without the permission of the client, however, he may not turn them over to others who do not have the same relationship to the client which he has had.

PROBLEMS—CHAPTER 18

Problem 18–1. The directors of the *X* Company frankly admit the existence of secret reserves, justifying the practice on the ground they are making provision for equalizing dividends in bad years, and ask you to certify to their statement and balance sheet nevertheless. You have confidence in their good faith. What should you do? (AIA)

Problem 18–2. For several years, including 1953, a public accountant had prepared statements and tax returns for the *F* Corporation. In August of 1954 he was approached by *M*, who, according to the newspapers, had purchased the *F* Corporation's business. *M* asked the accountant for copies of all statements previously made for the corporation, his stated intention being to use them for comparative purposes. *M* asserted that he had the financial records from the inception of the *F* Corporation. Explain fully how you would act if you were the public accountant confronted with such a situation and tell why. (AIA)

Problem 18–3. The balance sheet of the *A* Corporation shows as a fixed liability "First-mortgage bonds, $100,000." On inquiry you learn that these bonds mature within the next six months, and you inform the treasurer that you propose to show the item as a current liability. He explains that steps are being taken to refund the liability by a new issue of bonds at a lower rate of interest. From a survey of the finances of the corporation you are convinced that it will have no other means of meeting the debt. It so happens that another client of yours owns 90% of the bonds, and has boasted to you that he will soon obtain full possession of the *A* Corporation, which is a business rival. (*a*) What use will you make of this knowledge? (*b*) How will you treat this item on the *A* Corporation balance sheet? Give your reasons. (AIA)

Problem 18–4. (*a*) Your client, who owes money to his bank, has given the latter your annual report. The bank asks you for additional information. What will you do? Give reasons. (*b*) You are asked to audit the accounts of a company which had thus far been audited by another accountant in good standing. Will you accept the engagement? Give reasons. (*c*) At a meeting of the alumni of your college it was decided to found a scholarship. You agreed to contribute 15% of all the fees collected for work given you by the alumni or through their efforts, and considerable business came your way in that manner. You are accused of unprofessional conduct. State your defense. (AIA)

Problem 18–5. For a number of years you have audited the books and accounts of a concern which has just been thrown into receivership. You

are asked by the minority interests, who are instituting legal action for mismanagement, to audit the books and assist them in these proceedings. State the conditions under which you would accept the engagement or why you would decline it. (AIA)

Problem 18–6. Company *B* received from Company *A* a substantial order for merchandise, and upon shipment Company *B* rendered a bill to Company *A* for the goods purchased. Through the misplacement of a decimal point the amount of the bill was exactly one-tenth of what it should have been. Company *A* entered and settled the bill at the smaller amount and, at the time the usual audit was being made, had not heard from Company *B*. The auditor discovered the error, although he was not expected to check the purchase invoices for clerical accuracy. Company *A* had to admit the error but did not permit its correction, placing the responsibility on Company *B*.

The auditor was at some time later engaged by Company *B* for a balance sheet examination which likewise did not include a check of detail. Remembering the incident and anxious to see whether Company *A* had acknowledged the additional indebtedness and paid up, he found that the bill had also gone through Company *B*'s books at the lower amount, that the error had not been discovered, that Company *A*'s check had been received and credited in full settlement of the bill and that nothing had been heard from Company *A*.

State what the auditor should do in each examination. Give reasons. (AIA)

Problem 18–7. An auditor, having completed his engagement and rendered his bill for $7,500, is tendered 100 shares of the capital stock of the client, par value $100 each, which he accepts in full settlement of his fee. Give entries and explain fully how the transaction should be recorded on the client's books and on the auditor's books: (*a*) if the shares had been newly issued; (*b*) if they had been reacquired by the company and carried as treasury stock. Are there any ethical considerations involved in such an arrangement? (AIA)

Problem 18–8. A manufacturing company which has been your client for several years acquires control of another manufacturing company on April 1, 1954. The 1953 accounts of this subsidiary had been examined by independent public accountants. You are requested to make the 1954 examination with the object of consolidating the accounts of the two companies at the end of the year. Discuss to what extent and purpose the accounts for the periods prior to 1954 should be examined. (AIA)

Problem 18–9. A client maintains several branch offices throughout the country, where practically all accounts receivable ledgers are kept. Accounts

receivable represent a significant proportion of the total assets of the concern. An internal auditing staff regularly examines the branch office accounts and circularizes the receivables. All other accounts can be satisfactorily examined at the head office. The concern is well managed, its accounts in the past have been conservatively stated, and from the work done at the head office there is no reason to question the accuracy and completeness of the reports of the internal auditors. The client proposes that you limit your examination to the head office records, and rely on the internal auditor's reports as to the accounts receivable maintained at the branches. State in what way you would amend the standard short-form report or certificate in this case, and give reasons for any amendment. (AIA)

Problem 18–10. What is the meaning of "independence" as applied to independence of accountants? Cite evidences of lack of independence, and rules of professional conduct prohibiting actions which might result in impairment of accountant's independence. (AIA)

Problem 18–11. During the course of your examination you note certain disbursements charged to promotion expense. There is no supporting detail, but the vouchers were approved by the president. The related checks, made payable to cash, were signed by the treasurer, countersigned by an assistant treasurer, and indorsed by the treasurer. The officers refuse to furnish any further information. As independent auditor, what would you do, and why? (AIA)

Problem 18–12. Name four acts or situations which are regarded as contrary to ethical standards as generally recognized by the accounting profession. (AIA)

Problem 18–13. State your views as to the propriety of accepting a contingent fee in a professional accounting engagement. State reasons, noting exceptions, if any. (AIA)

Problem 18–14. A public accountant has a financial interest in an enterprise which he audits. Discuss the conditions under which it is proper and not proper, respectively, for the public accountant to express his opinion on the financial statements of the enterprise. (AIA)

Problem 18–15. Nearly one-third of the American Institute of Accountant's rules of professional conduct are concerned with the certified public accountant's independence. On the other hand, the legal profession is not concerned with the independence of lawyers. Why is there a difference as regards independence between the legal and accounting professions? (AIA)

Problem 18–16. In a customary annual examination of the accounts of a manufacturing company, the president of the corporation has requested that you confine your work to the balance sheet at the year end and certify to the balance sheet only. He contends that, if the balance sheet is verified and you have previously verified the balance sheet at the close of the preceding year, then the net income for the year must be the difference. Hence, he contends, there is no necessity for spending the time to check the income statement. What reasons would you advance for the desirability of checking the income and expense account in sufficient detail to permit certification thereof? (Disregard any income tax considerations.) (AIA)

Problem 18–17. An auditor makes an agreement with one of his clients that the amount of his audit fee will be contingent on the number of days required to complete the engagement. (*a*) What is the essence of the rule of professional ethics dealing with contingent fees, and what are the reasons for the rule? (*b*) Did the auditor violate the rule? (AIA)

Problem 18–18. For each of the following cases, state whether you believe the proposed action would be considered proper or improper according to the Rules of Professional Conduct of the American Institute of Accountants. Justify your decisions.

(*a*) A firm of certified public accountants is considering the use of an outside mailing service to handle confirmations of the accounts receivable of clients upon whose financial statements the firm is to render an opinion. The mailing service would mail the requests, receive the replies, remove the replies from the envelopes, and return them to the accountants.

(*b*) A certified public accountant, now on the staff of a firm of certified public accountants but contemplating public practice in his own name, plans to send announcements of his establishment in practice to clients of the firm in which he is now employed, as well as to friends and acquaintances. Some such clients have indicated that they would like him to continue to supervise their work; they are not aware of his decision to enter upon practice for himself.

(*c*) A certified public accountant, in the sale of his entire practice to another certified practitioner, proposes to turn over to the latter all of his working papers and business correspondence.

(*d*) A certified public accountant plans to initiate discussions with an accountant who is at present employed on the staff of another public accounting firm with a view to persuading the accountant to come to work for him. (AIA)

Chapter 19

REPORT WRITING

Report writing is essentially a matter of communication, of conveying information and ideas to someone else. This is true whether the report is prepared by an independent public accountant on the basis of a standard examination of the financial statements of a client company, an examination of a branch office by an internal audit department, or a limited investigation of some special problem by either. The reporting auditor has a message which he wishes to convey to those who will read his report; the report should be written in such a way as best to convey that message, giving due consideration to the difficulties of the information to be conveyed and to the knowledge and abilities of the anticipated readers.

In a general sort of way, an audit report will be concerned with one or more of three kinds of information: it may discuss the nature of the examination on which it is based; it may offer suggestions for improvement in internal controls or operating procedures; or it may explain the significance of the facts and figures discovered or verified during the course of the examination. All these are of a technical nature. It would be impossible to explain them so simply that someone with no knowledge of business whatsoever could comprehend them fully. In writing a report, therefore, an auditor must assume that his readers will have some basic knowledge of business operations, of accounting statements, and of the particular company to which the report pertains. This is not to say that the report writer may assume a technical knowledge on the part of his readers equal to his own. On the other hand, he need not write his report as if they knew nothing about business. Somewhere in between these two extremes lies a reasonable approach. In writing his report an auditor should take into consideration, in so far as he is able, any known limitations in the understanding of his readers; he must also deal realistically with his materials. He should never oversimplify his message to the point at which it becomes of little real worth.

Usually an auditor has had some previous experience with the prospective readers of his planned report. Where he has had no such experience it is well for him to discuss in a general way with the company manage-

ment what the report may include and to ask its opinion on this matter. After the report has been drafted, it is well to review it with the officials concerned in order to obtain any suggestions they may have for its improvement. Obviously an auditor cannot rewrite a report to include the ideas and views of those under examination. On the other hand, he should take advantage of any suggestions they are able to make with regard to understandability of the report, expansion of certain types of material, and the like.

An audit report should represent professional writing at its best. Once it leaves the auditor's hands he has no control over the use to which it may be put. A company may have every intention of using a report for internal purposes only, but, if it then becomes necessary to request credit from its bank, the audit report will almost certainly be called for by the bank. In writing his report, the auditor must keep in mind that he cannot know all its possible uses and must therefore exercise considerable discretion in its preparation.

As professional writing, the report must be clear, concise, moderate in statement, and above all must distinguish clearly between facts and opinions. Much of what an auditor reports is factual material verified or discovered during the course of his examination. This should be set out simply for what it is. To some extent, he is also expected to express his opinion on certain matters. For example, an independent auditor is expected to state his opinion whether or not the financial statements he has examined present fairly the results of operations and financial condition of the company under examination on the basis of generally accepted accounting principles consistently maintained. An internal auditor may be asked to express his opinion as to the effectiveness of certain internal control measures. Both are expected to make recommendations for improvements in internal control measures; such recommendations, of course, represent their own opinions of what might be suitable in the particular circumstances.

Whenever an auditor includes in his report material that is of an opinion rather than a factual nature, the wording of the text material must be such as to indicate this fact clearly. The expressions "in our opinion" and "we therefore recommend" as well as others of that type are useful as indications to the reader that the reporting auditor is going beyond verified facts in his presentation. It is not always easy to keep facts and opinions clearly separate, but this is one of the most important features of report writing. If an auditor fails to do so, his report is, to that extent at least, unsatisfactory.

In presenting factual material it is desirable to avoid excessive or extreme statements. The reader should be enabled to form an opinion from the facts themselves, not from the accountant's interpretation of the facts. For example, an auditor might feel that returns and allowances are excessive in view of sales. He should not say so in so many words in his report. He may compare returns and allowances for the current year with other years, pointing out any fluctuations in amount or rate; he might compare the company's ratio of returns and allowances to sales with that of others in the same line if that information is available; he may emphasize the importance of this item in a variety of ways. He should not state that it is excessive. This is a conclusion the reader should reach for himself.

Various other writing habits also should be avoided. "Your company had a great year," or "You are to be congratulated on your accomplishments," and similar expressions lower the professional character of an audit report. Separate and more personal communications should be used for congratulatory messages. The audit report itself should be objective and factual, not emotional or opinionated.

Types of Reports. There is a common misunderstanding on the part of beginning students of auditing to the effect that on any given engagement an auditor makes but one report, and that anything he wishes to bring to the attention of the company's management or stockholders must be included in that report. This is not a realistic understanding of the situation. During the examination and at other times throughout the year an auditor has many opportunities to convey his ideas to the company management. If the term "report" is considered broadly, all these communications may be included within the general field of reporting. For purposes of discussion they may be classified as:

1. Formal reports.
2. Informal reports.
   A. Written.
   B. Oral.

Formal reports, of course, are made in writing and summarize the results of an audit examination or special investigation. The examination need not be a complete audit of the concern's financial statements; even a limited examination directed at a single, special problem such as the cash transactions for a given period may culminate in a formal report. A formal report generally includes a statement as to the extent or purpose of the examination, followed by the auditor's findings, which

may be a statement of his opinion, certain recommendations for changes, or an explanation of the significance of the data examined, or a combination of these. The purpose of the report is to inform readers on the extent and results of the auditor's examination, and is at once a means of disclosing the extent of his responsibility and of discharging it by indicating what was discovered in the examination.

Informal reports provide an auditor with an opportunity of bringing to the attention of the company's management matters which he prefers to exclude from his formal report. The reasons for omitting such material from the formal report may vary a great deal. The auditor may find something, such as inadequate insurance coverage for valuable fixed assets, which he wishes to bring to the attention of management immediately rather than to wait until the time comes for presenting his formal report. Again, it may be a matter which would be inappropriate in a report that may ultimately be forwarded to the company's bank. A series of minor errors in bookkeeping may have no material effect on the financial statements but because they cause difficulties in the accounting department's operations may call for comment and even disciplining of the guilty party. A matter of this kind would be entirely inappropriate in a formal audit report, but might well warrant a special letter to the chief accounting officer. Recommendations for minor changes in internal control are seldom of sufficient interest to readers of audit reports to justify their inclusion therein; they should be made, however, and a brief letter to the appropriate officer may be the best means of so doing.

In addition to the letters that an auditor may use to convey information on a basis somewhat less formal than his audit report, he has the opportunity in conversations with the client company's officers and employees to pass on information or opinions that he feels they should have. During the course of the examination, company employees and officers often ask the various members of an audit staff questions as to the preferred method of accounting for given transactions or operations, questions as to what has been found with respect to a special problem, questions as to whether additional investigations of certain situations are in order. Often the answers to such questions are expected to be and can be extremely informal, and a brief conversation on the matter reaching a conclusion in answer to the request is sufficient. In other cases it may be desirable for the auditor to follow his oral discussion with a letter expressing his position more clearly or at greater length.

Thus an auditor, independent or internal, has many opportunities other than in his formal audit report to pass on information to the of-

ficers and employees of the company under examination. This permits him to exercise considerable restraint in selecting materials for inclusion in the formal audit report. He need not include everything in which he feels the company may have an interest. Immaterial or inappropriate matter may be excluded and communicated by some other means.

INDEPENDENT AUDITORS' REPORTS

Most examinations made by independent accountants are undertaken for the purpose of permitting them to express an opinion as to the company's financial statements. By far the bulk of the audit work done by independent public accountants consists of standard audits or examinations closely approximating the requirements of a standard audit engagement. When such an examination has been performed, the auditor is almost duty bound to form an opinion as to the reliability of the financial statements examined. As an expert accountant, he holds himself out as one who can determine the reliability of accounting data; on completing an examination he should therefore be in a position to express his professional opinion, his conclusion as to the fairness of the financial statements.

Such opinions may vary. It may be that the auditor finds that the facts as presented are reliable, and therefore a simple statement to the effect that the financial statements present fairly the financial condition and results of operations in accordance with generally accepted principles of accounting may be sufficient. On the other hand, it may be found that in some way the facts as presented are not all they should be. Inappropriate classification, inadequate disclosure of significant information, the use of procedures that are not generally accepted, or other faults may keep the auditor from feeling that the financial statements are satisfactory. In such a situation he should state in what way they are deficient. This is generally done by stating that, with certain exceptions, these being carefully described, the financial statements present fairly the financial condition and results of operations in accordance with generally accepted principles of accounting. In some cases, however, the deficiencies in the financial statements are so important as to cause the auditor to feel that he cannot express a favorable opinion even on a qualified basis. If this is because of certain unsatisfactory practices he has no alternative but to so state in his report and then refrain from expressing an opinion. If he feels that he has been unable to obtain sufficient reliable evidential matter to inform him fully on the reliability of the financial statements, he is expected to state that fact and then to

state further that he is unable to express an opinion on the financial statements as a whole. He may proceed to comment further on specific items in the financial statements, but his fundamental responsibility to come to a conclusion and to express it as his informed opinion has been discharged by his statement to the effect that he was unable to inform himself satisfactorily.

Thus an auditor has three alternatives; he can (1) state that the financial statements are reliable, that is, that they do "present fairly," (2) state that there is some qualification or limitation in his opinion of their reliability, which limitation must be clearly stated and explained, or (3) explain that the evidence in support of the facts is such that he can give no opinion as to the overall reliability of the financial statements. An independent auditor is expected to follow one or another of these three alternatives or quit the engagement in every case in which he has made an examination.

Contents of an Audit Report. Audit reports are commonly divided into two groups: short-form reports or opinions and long-form reports. A short-form report contains two essentials: a statement as to the scope of the audit, and a statement of the auditor's opinion based on his examination. The American Institute of Accountants has suggested a standard short-form audit report as follows:

Date

Addressee:

We have examined the balance sheet of *X* Company as of December 31, 19—, and the related statement(s) of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion the accompanying balance sheet and statement(s) of income and surplus present fairly the financial position of *X* Company at December 31, 19—, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

(*Signature*)

The first paragraph of this suggested form describes the scope of the examination; the second paragraph is an expression of the auditor's opinion. Breaking the report into two paragraphs emphasizes the distinction between fact, the scope of the examination, and opinion, the auditor's conclusion as to the fairness of presentation in the financial statements. Actually, however, it may be a matter of opinion whether

a given examination was performed in accordance with generally accepted auditing standards. Perhaps for this reason, some auditors tend to combine both scope and opinion in a single paragraph substantially as follows:

> In our opinion, the accompanying statement of financial position and statements of earnings, and earnings retained and invested in the business, present fairly the financial position of the *XYZ* Company at December 31, 1954, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. Our examination of these financial statements was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

To compose an adequate report, both scope and opinion should be included, although whether in one or two paragraphs does not seem a matter of great importance. In stating these essentials it is common practice to make use of certain expressions such as "generally accepted auditing standards" and "on a basis consistent with that of the preceding year" which although far from precise have considerable usefulness in describing auditing and accounting.

A few mechanical aspects of a short-form report are of importance. The report should be dated, the date used being the last date on which field work was performed. There is considerable question as to the extent of responsibility an auditor can accept for developments between the balance sheet date or audit date and the time of completion of his examination. There is much less question as to his responsibility once he completes his field work and leaves the client's office. Thus the last day in the field is important as indicating the termination of the period during which he might be held responsible for discovering events or other information pertinent to the audit report. For this reason it is commonly used as the date of the report.

The report should be addressed to the person or group from whom authority came to make the examination. Preferably this will be the stockholders, but may be the board of directors, the president of the company, or some other official.

Signing the report is commonly done in the name of the firm. Individual partners sign reports for examinations of the clients they control, but the signature is the name of the firm, not of the individual.

A long-form report differs from a short-form report in only one essential: the long-form report includes comments on various matters consid-

ered to be of interest to the readers of the report. Each type includes a date, an address, a statement as to the scope of the examination, a statement of opinion, and a signature. The long-form report also includes comments. These are discussed at some length later in this chapter.

A major problem of report writing common to both the long form and the short form of report has to do with phrasing the scope and opinion paragraphs when for some reason the standard wording is not applicable. This is discussed in the following section.

Problems of Opinion Writing. The problems of writing an appropriate opinion are largely those of considering and expressing the effect of qualifications and exceptions, these terms being used to indicate the existence of matters preventing an auditor from stating a straightforward approval of the financial statements as presented.

The standards of reporting set forth by the American Institute of Accountants require:

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.
2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.
3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

The first two of these are straightforward requirements of wording the report. The third requires the accountant to include in his report explanatory comment on any significant information that he feels has been omitted.

When it is remembered that the reason for an auditor's examination of the financial statements and supporting records of a company is for the express purpose of permitting him to form and state an informed opinion as to the reliability of the financial statements presented by that company, it becomes apparent that any qualification or exception in his opinion is of considerable importance. Under what conditions would he find it necessary to say something other than the approval indicated in the wording of the standard short-form report?

An auditor's qualifications with respect to stating his opinion in an audit report may be of three kinds:

1. With respect to the scope of the examination.
2. With respect to the accounting procedures followed by the company under examination.
3. With respect to the consistency with which accounting procedures are followed.

Exceptions with Respect to Scope. No authoritative statement is found anywhere in the professional literature with regard to the procedures and steps that must be taken in order that a given examination be adequate in scope. It is generally required that an examination be sufficient to satisfy a competent professional auditor with respect to the reliability of the data presented. Generally accepted auditing standards establish certain requirements, of course, but these are of a very general nature and not aimed at defining the scope of the average examination.

Two specific features of an audit examination have been accepted by the profession as required in those situations in which the items to which they relate are material. If inventories are a material factor in financial position or in determining the results of operations, the auditor is required to be present when the physical inventory is taken or to so indicate in his report. If receivables are a material factor in the financial position of the concern, he is required to apply the confirmation technique in his verification or examination of this account balance. Failure to follow either of these prescribed procedures calls for a statement of that fact in the scope portion of the report.

In addition to these two requirements, it might be stated in a general way that an auditor is expected to have made available to him every company record that might have a bearing on its financial position or results of operations. If, for example, a company under examination did not wish to open the minutes of its directors' or stockholders' meetings to its auditors, a complete examination would not be possible. Actions taken by either of these groups with respect to compensation of officers and employees, with respect to contracts and commitments, with respect to dividend declarations or policies, and many other matters are of vital interest to an auditor in judging the fairness of the company's financial statements. Such information must be made available to him if he is to make a satisfactory examination; if it is not made available, he should state that fact.

In the same way, if the contents of the company's safe deposit box allegedly consisted of company securities which were not made available to the auditor for his inspection and count, he would find it necessary to qualify the scope portion of his report.

As an independent contractor, an auditor should have complete freedom to use the company's records as he finds necessary in the performance of his examination. Any interference with that freedom, intentional or unintentional, calls for comment in the scope portion of his report. This is not to say that he must point out every invoice that was not located whether of importance or not. Materiality is always of importance and in matters of this kind is of first importance. No exception need be taken if the matter is of no real significance.

Limitations in the scope of an examination may in some cases be unavoidable; nevertheless they must be pointed out in the report. A company may find that it is unable to stop production long enough or to take sufficient employees from other activities to make a complete physical inventory. This, of course, makes it impossible for the independent auditor to be present when the inventory is taken. An explanation of this is therefore called for. On the other hand, it may be that the company specifically requests the auditor not to apply a given procedure. Because its customers do not wish to be bothered with monthly statements of account, or anything resembling them, a company may request that no circularization of accounts receivable be included in the audit engagement. Again, mention of this would be required. Secrecy with respect to a formula or process may make it impossible for an auditor to verify the costs of an inventory; this too calls for comment.

When it is not possible to make what we may call a complete or generally accepted examination, the scope portion of the report must be revised to indicate this. This is ordinarily accomplished by inserting into the last sentence of the first paragraph a description of the procedure omitted. If, for example, the auditors were not present when the physical inventory was taken, their report might read:

> With the exception that we were not present when the physical inventory was taken, our examination was made in accordance with generally accepted auditing standards ···.

If the auditor had not verified accounts receivable by confirmation, his exception might run:

> With the exception that we did not confirm the balances of customers' accounts by direct correspondence with the debtors, our examination was made in accordance with generally accepted auditing standards ···.

Any other omission of a generally required procedure would be mentioned in the same way.

The scope paragraph must thus be modified to indicate any deviation from generally accepted auditing standards. A second effect of such a

deviation has to do with the auditor's opinion. It seems apparent that if the auditor was unable to make a complete examination his opinion cannot be as well founded as if he had made such a complete examination. This is generally reflected by modifying the first sentence of the opinion paragraph somewhat as follows:

> In our opinion, subject to the exception stated in the preceding paragraph, the accompanying balance sheet together with the related statements of income and retained earnings present fairly ···.

or

> In our opinion, subject to the fact that we were not present when the physical inventory was taken, the accompanying ···.

In some cases a deficiency in the scope of an examination may be repaired through the application of additional procedures or through the expansion of others. For example, it may have been impossible to confirm accounts receivable, but through the examination of shipping documents and production records as well as tracing subsequent cash collections into bank deposits and the like an auditor may satisfy himself as to the reliability of the stated balances of the customers' accounts. When this is so it is not considered necessary to qualify the auditor's opinion. An exception would still be required in the scope paragraph of the auditor's report, but the wording of that exception would be such as to indicate that other audit evidence had been obtained. No exception or qualification would then be expressed in the opinion paragraph.

In the illustration just given, the scope paragraph might read as follows:

> With the exception that we did not confirm the balances of customers' accounts by direct correspondence with the debtors as to which we satisfied ourselves through the application of other auditing procedures, our examination was made in accordance with generally accepted auditing ···.

In some cases there is no completely satisfactory substitute for the omitted procedure. Here the auditor may feel it desirable to describe the steps that were taken in his examination although they were not completely satisfactory as an alternative. When this occurs, the required explanation may be too extensive to include within the scope paragraph. A third paragraph to be inserted between the scope and opinion paragraphs is sometimes used in such cases. This may call for some modification of both the scope and opinion paragraphs as well.

With the exception stated in the following paragraph, our examination was made in accordance with generally accepted ···.

Because of the demand for its product the company did not shut down production during the year under examination for physical inventory purposes and therefore took no physical inventory during the year. We made extensive tests of book inventory quantities by reference to production records, purchase invoices, and shipping records, tested prices by reference to current market quotations, and made extensive tests of the mathematical accuracy of inventory calculations. We found nothing during the course of our examination to cause us to question the company's inventory valuation as stated.

In our opinion, subject to the qualification described in the preceding paragraph, the accompanying ···.

In summary, it may be said that any material limitation on the scope of the examination imposed for any reason must be revealed in the scope paragraph. Unless compensated for by the application of other satisfactory procedures, the limitation affects the auditor's opinion and must be recognized in the opinion paragraph. If other auditing procedures can be employed by the auditor to satisfy himself as to reliability of the data in question he should so state in the scope paragraph and may then express his opinion without qualification. Sometimes it is considered desirable to insert a middle paragraph to explain the reason why a given procedure was omitted and to describe the steps taken by the auditor to supplement his examination of the item in question. This will generally call for reference to it in both the scope and opinion paragraphs.

Exceptions with Respect to Accounting Procedures. The opinion section of the recommended short-form report states that the financial statements present fairly "in accordance with generally accepted principles of accounting ···." This is considered to mean generally accepted within the specific trade or industry. Thus if a practice is followed which is somewhat at variance with what we might describe as generally applicable accounting procedure but is one generally followed within the trade or industry, no exception need be taken. For example, valuation of inventories at selling price in the meat-packing industry is a generally accepted practice within that industry although it is not considered acceptable in other lines of business.

Exceptions because of a failure to follow generally accepted principles of accounting are not frequent. When they occur it is generally necessary to explain them rather completely so that the reader has a clear conception of the problem. This usually requires a separate paragraph. Once the peculiar practice has been described, it must be re-

ferred to in the opinion paragraph because obviously the auditor cannot state in his opinion that generally accepted accounting principles were followed when he has described an exception to them.

In describing the peculiar practice or procedure, sufficient information should be made available to the reader to enable him to convert the financial statements to a generally accepted basis if he desires. That is, he should be told clearly and unequivocally the effect of the practice with respect to the results of operations and the financial condition so that he can take them into consideration in reading the financial statements.

To illustrate this type of exception, let us assume a situation in which a company has consistently followed the practice of charging all fixed assets to expense when purchased. This means that no fixed asset would appear in its balance sheet, and in the income statement, instead of showing depreciation as an expense, the additions during the current year would appear as an expense. The first paragraph of the auditor's opinion in such a situation might read in much the same way as the standard wording. A second paragraph to explain the deviation from generally accepted principles would be required, and reference to this would be called for in the opinion paragraph. The last two paragraphs might read somewhat as follows:

> The Rogers Company consistently follows the policy of charging all additions to its fixed assets to expense as purchased. During the year under review, additions to fixed assets costing $8,650 were charged to expense. Since the inception of the company, a total amount of $278,320 charged to expense could properly have been capitalized as fixed assets. Of this amount, $124,580 would have been charged as depreciation expense to December 31, 1953. Depreciation for the year under review would have been approximately $23,500 if the company had followed the orthodox procedure of capitalizing and depreciating fixed asset additions.
>
> In our opinion, the accompanying balance sheet and statement of income and retained earnings present fairly the financial position of the Rogers Company at December 31, 1953, and the results of its operations for the year then ended, in conformity with generally accepted principles of accounting, except as described in the preceding paragraph, applied on a basis consistent with that of the preceding year.

Exceptions with Respect to Consistency. In some cases a change in practice calls for comment in an auditor's report, not because the new practice is a deviation from generally accepted practice but because the effect of the change is sufficiently material to cause the financial statements for the current year not to be comparable with those of the preceding year. The auditor states that the accounting principles are

applied on a basis consistent with that of the preceding year. When this is not so, he must so state.

A common illustration of this is found in the last few years when a company changes, for example, from the first-in, first-out method of inventory pricing to the last-in, first-out method. A change of this kind may have a substantial effect on the amount of profits reported in the income statement and also on the financial position as indicated by the balance sheet.

The disclosure of this change is often made in a second paragraph in the auditor's report in much the same way as a variation from generally accepted accounting principles would be disclosed. The opinion paragraph then refers to the explanatory paragraph. In some cases a change may be so immaterial in effect as to call for nothing more than mention in the opinion paragraph, but such instances are not common. It has also become customary for the auditor to indicate his approval or disapproval, generally the former, in his opinion. The following illustrates one possible wording for such a short-form report. The first paragraph is omitted as it would not be affected by the change in accounting principles.

> During the year under examination the Lavell Company adopted the last-in, first-out method of pricing its inventories instead of the first-in, first-out method previously followed. This had the effect of reducing the profit for the period, after taxes, by the amount of $198,789 below what it would have been if this change had not been instituted. The price of the closing inventories on the first-in, first-out basis would have been $984,256.
>
> In our opinion, the accompanying balance sheet and statements of income and retained earnings present fairly the financial position of the Lavell Company at December 31, 1953, and the results of its operations for the year then ended in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year except as to the change in the basis of pricing inventories referred to in the preceding paragraph, which change we approve.

Reports When No Opinion Can Be Given. In the preceding sections of this chapter we have been concerned with situations in which an auditor might feel it necessary to include exceptions or qualifications in his opinion on a set of financial statements. Care must be taken in the drafting of such a report so that the reader is put on proper notice as to the extent and effect of the exceptions but at the same time is given such assurance as possible as to the reliability of data in the statements. Under other conditions it may not be possible for an independent auditor

to offer an opinion on the financial statements as a whole. In such cases care is also required so that a reader may not be misled into thinking that the auditor has offered an opinion or in any other way approved the statements.

Failure to give an opinion may result from either of two causes: (1) an examination that is not considered adequate, or (2) exceptions or qualifications so material as to negate an opinion.

In addition to complete audit examinations, public accountants are often called on for a variety of other services. Among these is the preparation of financial statements from the books and records kept by a client without audit or examination by the auditor. Many companies have bookkeeping departments able to record the daily transactions as they take place but unable to make such adjustments as are needed at the close of the period or to prepare financial statements. They therefore employ a firm of public accountants to do this for them. Sometimes they also request the accountants to give the records a cursory examination for obvious errors, to prepare bank reconciliations, to calculate depreciation, and the like. The work of the accountant under such an engagement is still a long way from an audit examination and omits many of the tests and procedures he would feel were essential if he intended to give an opinion.

In such cases it is obvious that the auditor cannot write a report containing an opinion. He has not collected sufficient evidential matter to place him in a position to offer his opinion as to the reliability of the financial statements.

The problem therefore is not one of writing an opinion, rather it is a problem of refraining from appearing to give an opinion. If, for example, the statements are typed on the stationery of the public accountant or if it is known that the statements have been prepared by an independent auditor, many readers are likely to assume that they therefore have his approval. Many readers are not sufficiently aware of the importance of the auditor's opinion to realize the significance of its omission in such cases.

For this reason it is considered desirable and even necessary to take steps to prevent misunderstanding in situations where the accountant prepares statements for a client without first making an examination. The approved practice is to write across each page of the financial statements: "Prepared from the books without audit." This should signify to anyone that no responsibility for the reliability of the data included is taken by the accountant whether the statements appear on his station-

ery or it is merely common knowledge that he has prepared them. This is a desirable practice so that readers of financial statements may develop a consciousness and respect for auditors' opinions and so that they will not have a feeling of being misled. Nothing would work more to destroy the standing of independent auditors than a feeling on the part of those who read financial statements that they didn't know when they could depend on an auditor and when they could not. Any reasonable steps to prevent such misunderstanding seem highly desirable.

If an auditor, after completing an examination, finds that he must include an exception in his report, and if that exception relates to material items, his opinion may become meaningless. For example, if we assume a rather extreme situation in which a company's current assets make up the majority of its total assets and in which receivables and inventory together constitute more than 80 per cent, let us say, of the current assets, these two items become of primary importance. If the auditors are not present when the physical inventory is taken and if they do not confirm the receivables, they must take exception in the scope paragraph of their report and refer to this in the opinion paragraph. But the question should be raised whether an opinion that does not cover a major portion of the company's assets can mean anything at all. Is an opinion of any value if such material items as the inventory and receivables in the example under consideration are specifically excluded?

It is a general feeling that to give an opinion in such a case is not a reasonable thing to do. The exceptions negate the opinion because of their importance. When the exceptions are such as to negate the opinion, it is best that no opinion be given.

Thus whenever an auditor has an exception to be expressed in his report he must give serious consideration to the materiality of the exception and its effect on the financial statements as a whole. Any exception or qualification, whether it relates to scope, generally accepted principles of accounting, or consistency between years, if sufficiently material may negate the entire opinion. In such a situation no opinion should be given.

Although it may not be appropriate to give an opinion as to the fairness of the statements as a whole, it may be possible and entirely proper to express an opinion as to specific items in the statements. In the example previously mentioned it might be possible to state that in the auditor's opinion certain items such as cash, investments, and current liabilities are stated fairly and in accordance with generally accepted

principles of accounting. If the auditor first disclaims any opinion on the statements as a whole, it is considered acceptable reporting practice for him to then proceed to comment on those items which he feels are presented fairly.

The following report indicates a possibility in this respect:

> We have examined the balance sheet of the Carl Corporation as of December 31, 1953, and the related statements of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances as explained in the following paragraph.
>
> Because of the demand for the company's product, the company did not close down production during the year under examination for physical inventory purposes and took no physical inventory during the year. We made extensive tests of book inventory figures for accuracy of calculation and reasonableness of pricing. We did not make physical tests of inventory quantities. Because of the materiality of the inventory amount with respect to the net income for the year and the financial condition of the company, we are unable to express an opinion on the financial statements taken as a whole.
>
> Except for the accuracy of the inventory as stated, in our opinion the accompanying balance sheet presents fairly the assets and liabilities of the Carl Corporation at December 31, 1953, in accordance with generally accepted principles of accounting applied on a basis consistent with that of the preceding year. Subject to the effect of the inventory on the profits for the period and on the amount shown as cost of goods sold, the accompanying statements of income and of retained earnings present the incomes and expenses for the year and the result of transactions affecting retained earnings in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

It seems quite apparent that any qualification weakens the strength of the auditor's opinion and should be avoided if at all possible. Full discussion with the client in advance of commencing the audit is one of the best ways to avoid the necessity for such deleterious statements in audit reports. Every effort should be made to point out to the client the disadvantages of a limited examination as well as the improprieties in his accounting methods so that qualified reports and so-called "piecemeal" opinions may be reduced to the minimum.

Comments in Long-Form Audit Reports. A long-form audit report includes all the essentials of a short-form report or opinion plus com-

ments by the auditor on the results of operations and financial condition. Often a short-form report very similar to the standard form is presented first; this is separated by a line of asterisks or some other marking from the comments which follow. Sometimes the accountant's signature follows the short-form opinion and therefore precedes the comments; sometimes it is added at the end of the comments. Frequently two reports are given, one a short-form report with financial statements for publication purposes, the other a long-form report with an opinion, comments by the auditor, and detailed financial statements for the board of directors and management personnel.

The auditor's comments may be of two types. Procedural comments describe in an abbreviated way the steps taken by the auditor in his examination of the various items discussed. Explanatory comments, on the other hand, discuss the information in the income statement and balance sheet from a business point of view and attempt to make the information contained in them more intelligible to the reader of the report. In the past, procedural-type comments were very common and provided the bulk of most long-form reports. They stated what the auditor had done with respect to almost every balance sheet item and to some extent did the same for major items or groups of items in the income statement. With the development of standard forms of opinion and more general acceptance of the professional status of the independent auditor, it has become less necessary to explain in detail the nature of his examination. Further, independent accountants have proved themselves to be business men with sound ideas and an ability to explain business activities and conditions. This provides the opportunity for explanatory-type comments.

Explanatory-type comments may be of a considerable variety. They may explain the increase or decrease in the rate of gross profit from one year to the next. They may include an analysis of the change in working capital position from one balance sheet date to the next. They may point out which expenses have increased or decreased in one year as compared with the other, and to the extent possible they may explain why. Their aim is to give the reader of the report information of a factual and interpretive nature that will permit him to understand better the financial statements and to come to conclusions as to what steps may be necessary in view of the situation as described. They do not in themselves recommend action. They merely present factual data in such a way that a business man can use it in the formulation of his own decisions as to the desirability of taking action.

To contrast the typical procedural type of comment with the explanatory type, accounts receivable may be taken as an example. The two types of comment might well run something like this:

PROCEDURAL-TYPE COMMENT

Accounts Receivable: $286,573. The accounts receivable were circularized and satisfactory replies received from approximately sixty per cent of those to whom confirmation requests were mailed. The accounts were aged and all balances in excess of ninety days were investigated. Mr. S. C. Gartch, Treasurer, assured us that all balances not provided for in the Reserve for Doubtful Accounts appear collectible.

EXPLANATORY-TYPE COMMENT

Accounts Receivable: $286,573. All accounts represent receivables resulting from ordinary sales transactions. Accounts receivable at December 31, 1953, represent 25.7% of total current assets as compared with 19.8% a year ago.

The age of the accounts receivables is summarized as follows:

	12/31/54	12/31/53
Under 30 days	$179,416	$148,315
30 to 60 days	46,425	28,641
60 to 90 days	13,712	18,934
90 to 180 days	12,851	17,110
Over 6 months	34,169	22,688
Total	$286,573	$235,688

The increase in the proportion of total current assets made up of accounts receivable and the increase in the amount of accounts receivable over six months old indicates an increasingly serious situation.

Provision has been made for estimated losses on uncollectible accounts equal to eight per cent of total accounts receivable, or $23,925. This amount appears adequate on the basis of a careful review of all overdue accounts.

Illustrative Long-Form Audit Report. Because of the wide variety of possibilities in the preparation of long-form audit reports, it is not feasible to attempt to present a standard or model report. Each report should be drafted as a special problem with the facts of the given situation in mind. This means that in some cases one type of information will be developed, whereas in another situation a different approach may be called for. The following illustrative report is presented not as a model or standard but only as an indication of the way in which such a

report might be prepared. The value of any long-form report depends far more on the imagination and ingenuity of the auditor than on any model or form he might attempt to follow.

Many long-form audit reports are bound in a cover carrying the name of the company examined and the name of the auditors. An index is often included, listing each financial statement and the major divisions of the comments section. It is also customary to identify each financial statement and exhibit with a number or letter for reference purposes. As the accompanying illustrative report is relatively brief and includes only the minimum in formal financial statements, an index seems unnecessary.

Test, Prove, and Company
Certified Public Accountants
Chicago, Illinois

March 3, 1955

Board of Directors
The Clement Company

We have examined the balance sheet of The Clement Company as of December 31, 1954, and the statements of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying balance sheet and statements of income and retained earnings present fairly the financial position of The Clement Company at December 31, 1954, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Test, Prove, and Company

. . . .

In connection with the accompanying financial statements we submit the following comments:

Results of Operations

Operations for the year ended December 31, 1954, resulted in a net income of \$176,734, which represents an increase of \$43,311, or 32%, over the net income of \$133,423 for the preceding year.

The following summary of the results of operations for 1954 and 1953 is helpful in pointing out the reasons for the increase in net income:

	Year ended December 31		Difference	
	1954	1953	Inc., Dec.*	
Sales	$3,468,525	$2,972,413	$496,112	16.7%
Cost of sales	2,119,583	1,982,541	137,042	6.9
Excess of sales price over cost of sales	$1,348,942	$ 989,872	$359,070	36.3
Selling expenses	$ 603,513	$ 453,028	$150,485	33.2
Administrative expenses	358,380	310,771	47,609	15.3
Total operating expenses	$ 961,893	$ 763,799	$198,094	25.9
Net profit on operations	$ 387,049	$ 226,073	$160,976	71.2
Other income	5,580	11,410	5,830 *	51.1
	$ 392,629	$ 237,483	$155,146	65.3
Other expense	23,895	26,060	2,165 *	8.2
Net profit before taxes	$ 368,734	$ 211,423	$157,311	74.4
Provision for federal income taxes	192,000	78,000	114,000	146.2
Net income for the year	$ 176,734	$ 133,423	$ 43,311	32.4

As indicated by this summary, the factors tending to increase net profit are:

An increase in sales of 16.7% with a corresponding increase in cost of goods sold of only 6.9%, resulting in an increase in gross profit of	$359,070	
A minor decrease in other or nonoperating expenses of	2,165	
Total factors increasing net income		$361,235

Factors tending to decrease net profit include:

An increase in selling expenses of 33.2% and an increase in administrative expenses of 15.3%, resulting in an increase in operating expenses of	$198,094	
A decrease of 51.1% in other income of	5,830	
An increase of 146.2% in federal taxes on income of	114,000	
Total factors decreasing net income		317,924
Increase in net income		$ 43,311

The increase in sales follows chiefly from an increase in unit selling prices, although there has also been a slight increase in the volume of merchandise sold. Costs of merchandise purchased by the company increased substantially in 1953 and have remained generally uniform during 1954.

Other or nonoperating expenses in 1953 were larger than in 1954, chiefly because of sales of equipment below depreciated book values. Mr. William Capener, general manager, has expressed himself as expecting no substantial sales for several years of equipment now in use.

An increase of $83,842 in salesmen's salaries and commissions accounts for more than one-half of the total increase of $150,485 in selling expenses. Other substantial increases in this classification are as follows:

Account	Amount of Increase
Travel and entertainment	$17,865
Advertising	15,845
Shipping supplies and expense	23,713

Officers' salaries increased $38,000, or 21.5%, from 1953 to 1954. This and an increase of $5,000 in insurance costs account almost completely for the increase in administrative expenses.

The greatest increase in any single expense is found in the increase in federal income taxes which in the current year took approximately 52% of the total income of the company before taxes.

Financial Position

The current position of the company, although still satisfactory, is not as strong at December 31, 1954, as it was at the end of 1953. This is indicated by the following summary of the current assets and current liabilities:

	Balance at December 31		
Current Assets	1954	1953	Increase Decrease *
Cash	$ 45,381	$ 42,485	$ 2,896
Marketable securities	15,250	28,250	13,000 *
Receivables—net	250,730	186,974	63,756
Inventories	615,117	489,713	125,404
Prepaid expenses	28,286	26,032	2,254
Total current assets	$954,764	$773,454	$181,310
Current Liabilities			
Accounts payable	$235,781	$187,532	$ 48,249
Notes payable and accrued interest	10,300	50,500	40,200 *
Accrued federal income taxes	192,000	78,000	114,000
Other	12,300	9,920	2,380
Total current liabilities	$450,381	$325,952	$124,429
Net working capital	$504,383	$447,502	$ 56,881
Ratio of current assets to current liabilities	2.12	2.37	
Ratio of cash, marketable securities, and receivables to current liabilities	.69	.79	

The ratio of current assets to current liabilities has declined from 2.37 to 1 at December 31, 1953, to a less satisfactory 2.12 to 1 at December 31, 1954. In addition, at the latter date, the investment in inventories, one of the least liquid of the current assets, is greater than it was at the previous balance sheet date. The amounts of cash, marketable securities, and receivables are proportionally smaller. This results in a lower ratio of liquid assets, cash, securities, and receivables, to current liabilities. In view of the burden of federal income taxes and the resulting strain on the company's liquid assets, it is desirable that some attention be given to improving the company's working capital position before any undesirable trends become serious.

During the year under review, the company disposed of long-term investments for $61,000, their approximate cost and book value. Hence neither gain nor loss was realized on this transaction. During the course of the last several years, dividends received on the investments sold during 1954 amounted to approximately $5,000 a year.

An addition to the main building was completed during 1954 at a cost of $150,000, and was occupied late in the year. At rates of depreciation considered reasonable under the circumstances, this will add annual depreciation of $4,500 to the fixed expenses of the company.

No additional debt was incurred in connection with the completion of this construction. Funds provided by operations and by sale of investments were sufficient to pay for it completely.

The financial transactions for the year are summarized in the following statement of resources provided and applied:

Resources provided	
By operations—after adjustment of net income for costs and expenses not requiring the expenditures of resources during the current year	$208,781
By sale of long-term investments	61,100
Total resources provided	$269,881
Resources applied	
To acquisition of buildings	$150,000
To payment of dividends	63,000
To increase in working capital	56,881
Total resources applied	$269,881

This summary indicates that operating activities and the sale of long-term investments together brought new resources into the company in the amount of $269,881. This was used to pay for the addition to the main building, $150,000, to pay dividends to shareholders of $63,000, and to add $56,881 to the company's working capital.

The accompanying financial statements present the results of operations and the financial position of the company in greater detail.

Exhibit I

THE CLEMENT COMPANY
STATEMENT OF INCOME
FOR THE YEAR ENDED DECEMBER 31, 1954

Sales			
Gross sales (after deducting returns and allowances of $28,642 and cash discounts of $51,418)			$3,468,525
Cost of Sales			
Merchandise inventory January 1, 1954	$ 489,713		
Cost of merchandise purchased			
Invoice cost (after deducting discounts of $20,540)	2,203,471		
Freight and other transportation	41,516		
Total merchandise available		$2,734,700	
Deduct cost of merchandise not sold—inventory at December 31, 1954		615,117	2,119,583
Excess of sales price over cost of goods sold			$1,348,942
Operating Expenses			
Selling expenses			
Salesmen's salaries and commissions	$286,486		
Sales office salaries	61,350		
Travel and entertainment	56,180		
Advertising	64,785		
Telephone and telegraph	13,126		
Freight and transportation out	28,825		
Shipping supplies and expense	64,912		
Postage and stationery	11,061		
Depreciation of sales equipment	16,788	$603,513	
Administrative expenses			
Officers' salaries	$214,000		
Office salaries	65,300		
Legal and professional services	22,185		
Telephone and telegraph	8,140		
Insurance	28,720		
Depreciation of buildings	6,000		
Depreciation of office equipment	8,059		
Stationery, supplies, and postage	3,162		
Miscellaneous office expenses	2,814	358,380	961,893
Net profit on operations			$ 387,049
Other Income			
Dividends received		$2,500	
Rentals		2,100	
Sales of waste and perishables		980	5,580
			$ 392,629
Other Expense			
Interest on bonds and notes		$21,800	
Amortization of bond discount and expense		1,200	
Loss on sale of equipment		895	23,895
Net income before provision for federal taxes on income			$ 368,734
Provision for Federal Taxes on Income			192,000
Net income for the year			$ 176,734

Exhibit II

THE CLEMENT COMPANY
STATEMENT OF RETAINED EARNINGS
FOR THE YEAR ENDED DECEMBER 31, 1954

Retained earnings, January 1, 1954		$196,582
Add net income for the year		176,734
		$373,316
Deduct dividends declared and paid:		
Preferred: $5.00 a share	$15,000	
Common: $12.00 a share	48,000	63,000
Retained earnings, December 31, 1954		$310,316

Exhibit III

THE CLEMENT COMPANY

BALANCE SHEET

DECEMBER 31, 1954

Assets

Current Assets				
Cash			$ 45,381	
Marketable securities—at cost (market value, $15,825)			15,250	
Accounts receivable				
Customers	$226,450			
Employees	8,450	$234,900		
Less estimated uncollectible accounts		2,170	232,730	
Notes receivable			18,000	
Inventories—at lower of cost of market			615,117	
Unexpired insurance, supplies, and other prepaid expenses			28,286	$ 954,764
Long-Term Investments				
Miscellaneous stocks and bonds—at cost (market value approximately $25,900)				26,400
Tangible Fixed Assets				
Land—at cost			$125,000	
Buildings and equipment—at cost		$1,125,800		
Less accrued depreciation		372,047	753,753	878,753
Intangible Fixed Assets				
Goodwill				100,000
Deferred Charges				
Unamortized bond discount and expense			$16,800	
Market research and development costs deferred			21,480	38,280
Total assets				$1,998,197

Liabilities and Shareholders' Equity

Current Liabilities				
Accounts payable			$235,781	
Notes payable to banks			10,000	
Accrued interest on notes payable			300	
Accrued federal income taxes			192,000	
Accrued salaries, wages, and other expenses			12,300	$ 450,381
Long-Term Debt				
Twenty-five-year 4% debentures payable, due January 1, 1966				500,000
				$ 950,381
Shareholders' Equity				
Paid in on capital stock				
5%, cumulative, preferred				
Authorized and outstanding, 3,000 shares of $100 par value		$300,000		
Common				
Authorized, 5,000 shares of $100 par value; issued and outstanding, 4,000 shares		400,000		
Excess of issue price over par value of common stock		37,500	$737,500	
Earnings retained in the business			310,316	1,047,816
Total liabilities and shareholders' equity				$1,998,197

PROBLEMS—CHAPTER 19

Problem 19–1. May a certificate of a balance sheet be qualified without necessarily reflecting on the validity of the balance sheet? If in your opinion such may be the case, state the conditions and write two certificates as illustrations. (AIA)

Problem 19–2. (*a*) Does the certificate of an auditor constitute a guarantee by him? (*b*) What is the value and significance of his certificate? Discuss fully. (AIA)

Problem 19–3. What criticisms have you to make of each of the following certificates?

(*a*) We have audited the accounts of the *A B* Company for the year ended December 31, 1954, and we certify that the foregoing statement of receipts and disbursements is in accordance with the books of account.

(*b*) We have audited the books and accounts of the *A B* Corporation and of its subsidiaries, the *D E* Company, and the firm of *F* & *G*, for the year ended December 31, 1954, and we hereby certify that, in our opinion, the accompanying consolidated balance sheet and consolidated statement of income and profit and loss correctly exhibit respectively the financial position of the *A B* Corporation and its subsidiaries at December 31, 1954, and the results of operation for the year ended at that date.

(*c*) We have audited the books and accounts of the *A B* Corporation for the year ended December 31, 1954, have examined the related records of original entry and supporting documents, including monthly reports received from branches and subsidiaries, and we hereby certify that the accompanying consolidated balance sheet and consolidated profit and loss account correctly exhibit the consolidated financial condition of the companies and their consolidated income results for the year.

(*d*) (At the foot of the statement) "Audited and found correct." (AIA)

Problem 19–4. Briefly state the extent of the auditing procedure implied by a public accountant who renders an unqualified standard short-form report, sometimes designated as the short-form certificate or opinion. (AIA)

Problem 19–5. A mercantile corporation has consistently valued its inventory on the basis of cost or market, whichever is lower. At the close of the year under examination it changed from the "first-in, first-out" to the "last-in, last-out" method of determining cost. As a result of the change, the net income and federal income taxes have been substantially reduced. How should the change be disclosed in the auditor's report? (AIA)

Problem 19–6. Name the essential elements of an auditor's certificate or report, and write a typical short-form certificate. (AIA)

Problem 19–7. What would be the effect of each of the following conditions on the auditor's reports or certificates:

(*a*) Accounts receivable are significant in amount. The client refused to permit their confirmation by direct correspondence, and no other satisfactory means of establishing the substantial correctness of the total were available.

(*b*) The client refused to permit you to examine the minutes of board of directors meetings.

(*c*) The client has an account receivable, substantial in amount, from a wholly owned subsidiary. The company has expressed its willingness to request the subsidiary to confirm the amount of its indebtedness directly to you. However, it refused to give you access to the books and records of the subsidiary. (AIA)

Problem 19–8. A client corporation requests you, as auditor, to sign published statements of its expected earnings. What position would you take with respect to the request? Give reasons. (AIA)

Problem 19–9. After examining the following report, (*a*) criticize it fully and (*b*) write a corrected report.

To the Board of Directors of
The *ABC* Corporation:

We have examined the accounts of the *ABC* Corporation for the year ended March 31, 1954. We have examined and tested the accounts and records of the company and reviewed the accounting methods in operation. We have examined the report submitted by *X* and *Y*, chartered accountants, who have audited the subsidiary corporation of Toronto, Canada.

The president certified the inventories as being valued at the lower of cost or market. We verified inventory summary computations for clerical accuracy. Accounts receivable were not confirmed. All liabilities have been included in accordance with the accounting records. The accounting principles and practices followed by the company are in accordance with commonly accepted principles and procedures for the industry and have been consistently maintained during the year.

In our opinion, the accompanying consolidated balance sheet and related consolidated statement of profit and loss correctly present the financial condition of the corporation at March 31, 1954, and the results of operation for the fiscal year then ended.

(AIA)

INDEX

SHORT AUDIT CASE

CONTENTS

ASSIGNMENTS

1. Read introductory material and review of internal control, look over general ledger accounts, and prepare audit program.
2. Prepare general ledger trial balance, taking 1954 balances directly from general ledger.
3. Complete verification and prepare work papers for cash.
4. Complete verification and prepare work papers for the payroll account and for accounts receivable
5. Complete verification and prepare work papers for inventories. Review prepaid insurance analysis supplied to you by Mr. Moffitt and perform any additional work you consider necessary.
6. Bring work papers on fixed assets up to date. Review depreciation provisions and perform any additional work you consider necessary.
7. Complete verification and prepare work papers for accounts payable.
8. Complete verification of remaining balance sheet accounts.
9. Complete trial balance and prepare financial statements.
10. Draft long-form report.
11. Draft long-form report.

INTRODUCTION

The Better Bottling Company is engaged in the manufacture and sale of a nationally advertised soft drink. It is a closely held corporation located in a community of about 60,000 people. The stock of the company is held equally by three brothers who have a variety of business interests. They have engaged Mr. John Landgren to serve as general manager on an arrangement providing for a basic salary and a bonus based on the profits for each year.

The product is made from a patented mixture based on a secret formula and supplied by a nationally known distributor. To the basic mixture the Better Bottling Company adds only water and carbonic gas. Automatic machinery washes the bottles, fills them, first with a measured amount of the basic syrup, and then measured amounts of carbonated water, caps them, and passes them on to an assembly table from which they are loaded into cases for distribution.

Plant workers handle the returned empty bottles, control the machinery, inspect the washed and filled bottles, and place the filled bottles in cases for distribution to customers.

The product is distributed in company-owned trucks; each of the drivers is assigned to an established area. In addition to a basic salary, drivers receive a commission on each case sold and a smaller commission on each case of empties returned. This encourages them to serve their assigned areas effectively, to conserve bottles, and to develop new customers.

Sales to most customers are for cash. Certain large customers who have established credit with the company are billed monthly.

Each truck driver is charged for the total number of cases he takes out each day. When he checks in at the end of the day he is credited for product returned unsold, for cash collections turned in, and for empty bottles and cases returned from customers. The difference must be charged to accounts receivable and must be supported by detailed charge tickets

signed by customers. These tickets become the basis for posting to the customers ledger.

This company has been a client of your employers, Check and Prove, CPA's, for some time, but this is the first time you have been assigned to the examination. You are to be in charge of the engagement, including development of the audit program, subject to the review of Mr. A. B. Prove who supervises the work done for this client. You will have an assistant assigned to you for such duties as you find necessary.

Preliminary arrangements provide that you are to be present during the taking of the physical inventory on December 31. Accounts receivable confirmations will be mailed out by your assistant as of December 31 while you are supervising the inventory taking. Positive confirmation requests will be used, and replies should be available for your review by January 15 when you are to return for final work.

Petty cash will be counted at December 31. The December bank statements will be held unopened until January 15 when you return to finish the examination.

The review of the company's internal control procedures in the permanent file was brought up to date by Mr. Prove in an interview with the office manager in December and is available for your use during the examination. He also took excerpts from minutes of the stockholders' annual meeting and from the minutes of the board of directors' meetings.

You are to make a standard examination and to submit a long-form report after its completion.

The tax rate may be assumed to be 25% for purposes of accruing federal income taxes for the year.

COMPANY RECORDS AND OTHER INFORMATION OBTAINED FROM CLIENT

GENERAL LEDGER

#11 Petty Cash

1/2/54	Fwd.	100.00			

#12 Cash—General

1/2/54	Fwd.	27,765.42	1/31/54	CD	12,618.64
1/31	CR	11,828.00	2/28	CD	11,619.23
2/28	CR	11,019.00	3/31	CD	21,500.71
3/31	CR	12,879.00	4/30	CD	20,781.64
4/30	CR	13,480.00	5/31	CD	13,155.44
5/31	CR	15,356.00	6/30	CD	21,787.38
6/30	CR	26,379.00	7/31	CD	20,540.29
7/31	CR	34,930.00	8/31	CD	25,883.91
8/31	CR	32,225.00	9/30	CD	22,389.60
9/30	CR	28,866.00	10/31	CD	18,476.55
10/31	CR	17,639.00	11/30	CD	21,642.45
11/30	CR	12,024.00	12/31	CD	12,259.19
12/31	CR	11,519.00			222,655.03
		255,909.42			

#13 Payroll Account

1/2/54	Fwd.	300.00			

#16 Accounts Receivable

1/2/54	Fwd.	10,171.50	1/31/54	CR	3,258.00
1/31	CR	5,897.00	2/28	CR	5,347.00
2/28	CR	4,299.00	3/31	CR	4,412.00
3/31	CR	4,903.00	4/30	CR	4,817.00
4/30	CR	5,722.00	5/31	CR	5,850.00
5/31	CR	6,470.00	6/30	CR	6,332.00
6/30	CR	7,823.00	7/31	CR	8,157.00
7/31	CR	8,158.00	8/31	CR	7,820.00
8/30	CR	10,983.00	9/30	CR	8,060.00
9/30	CR	5,912.00	10/31	CR	5,205.00
10/31	CR	6,017.00	11/30	CR	4,812.00
11/30	CR	3,843.00	12/31	CR	4,110.00
12/31	CR	4,702.00			68,180.00
		84,900.50			

#18 Inventories

1/2/54	Fwd.	13,869.90			

#19 Unexpired Insurance

1/2/54	Fwd.	1,689.68	12/31/54	J	1,767.06
2/20	CD	480.00			
6/18	CD	786.42			
		2,956 10			

#20 Machinery and Equipment

1/2/54	Fwd.	43,100.00			

#21 Accrued Depreciation—Machinery and Equipment

			1/2/54	Fwd.	14,707.00
			12/31	J	4,310.00
					19,017 00

#22 Delivery Equipment

1/2/54	Fwd.	25,520.00	8/5/54	J	2,240.00
8/5	CD	2,450.00			
		27,970 00			

#23 Accrued Depreciation—Delivery Equipment

8/5/54	J	2,240.00	1/2/54	Fwd.	6,512.00
			12/31	J	2,412.00
					8,924 00

#24 Office Furniture and Equipment

1/2/54	Fwd.	1,980.00			

#25 Accrued Depreciation—Office Furniture and Equipment

			1/2/54	Fwd.	557.00
			12/31	J	198.00
					755.00

#26 Coolers

1/2/54	Fwd.	19,500.00			
4/10	CD	6,000.00			
		25,500 00			

#27 Accrued Depreciation—Coolers

			1/2/54	Fwd.	4,875.00
			12/31	J	1,950.00
					6,825.00

#31 Accounts Payable

1/2/54	J	2,301.35	1/2/54	Fwd.	2,301.35
			12/31	J	3,269.70
					5,571 05

#33 Employees' Taxes Withheld

1/31/54	CD	489.98	1/2/54	Fwd.	489.98
2/28	CD	557.30	1/31	CD	557.30
3/31	CD	560.91	2/28	CD	560.91
4/30	CD	551.49	3/31	CD	551.49
5/31	CD	551.34	4/30	CD	551.34
6/30	CD	556.94	5/31	CD	556.94
7/31	CD	568.42	6/30	CD	568.42
8/31	CD	664.11	7/31	CD	664.11
9/30	CD	685.01	8/31	CD	685.01
10/31	CD	696.94	9/30	CD	696.94
11/30	CD	647.82	10/31	CD	647.82
12/31	CD	556.67	11/30	CD	556.67
		7,086.93	12/31	CD	520.91
					7,607 84

#34 Accrued Social Security Taxes

1/2/54	J	444.14	1/2/54	Fwd.	444.14
			12/31	J	457.33
					901.47

#35 Accrued State and Local Taxes

1/2/54	J	900.00	1/2/54	Fwd.	900.00
			12/31	J	925.00
					1,825 00

#36 Federal Income Tax Accrued

3/10/54 CD	7,500.00	1/2/54	Fwd.	7,500.00

#41 Capital Stock

		1/2/54	Fwd.	75,000.00

#42 Earned Surplus

11/15/54 CD	7,500.00	1/2/54	Fwd.	30,710.03

#51 Soft Drink Sales

		1/31/54	CR	13,696.00
		2/28	CR	11,136.00
		3/31	CR	12,480.00
		4/30	CR	13,312.00
		5/31	CR	14,976.00
		6/30	CR	28,080.00
		7/31	CR	32,864.00
		8/31	CR	34,992.00
		9/30	CR	28,200.00
		10/31	CR	17,496.00
		11/30	CR	12,480.00
		12/31	CR	12,896.00
				232,608.00

#52 Case and Bottle Sales

		1/31/54	CR	8,560.00
		2/28	CR	6,960.00
		3/31	CR	7,800.00
		4/30	CR	8,320.00
		5/31	CR	9,360.00
		6/30	CR	17,550.00
		7/31	CR	20,540.00
		8/31	CR	21,870.00
		9/30	CR	17,625.00
		10/31	CR	10,935.00
		11/30	CR	7,800.00
		12/31	CR	8,060.00
				145,380 00

#53 Cooler Rentals

			1/31/54	CR	195.00
			2/28	CR	195.00
			3/31	CR	195.00
			4/30	CR	195.00
			5/31	CR	255.00
			6/30	CR	255.00
			7/31	CR	255.00
			8/31	CR	255.00
			9/30	CR	255.00
			10/31	CR	255.00
			11/30	CR	255.00
			12/31	CR	255.00
					2,820.00

#54 Discounts Earned

			1/31/54	CD	9.90
			2/28	CD	2.10
			3/31	CD	11.60
			4/30	CD	4.20
			5/31	CD	13.70
			6/30	CD	17.40
			7/31	CD	23.90
			8/30	CD	23.90
			11/30	CD	11.80
			12/31	CD	10.20
					128.70

#61 Soft Drink Syrup

1/31/54	CD	4,290.00	1/1/54	J	1,385.00
2/28	CD	3,575.00			
3/31	CD	3,575.00			
4/30	CD	4,290.00			
5/31	CD	4,647.50			
6/30	CD	8,580.00			
7/31	CD	10,010.00			
8/31	CD	10,725.00			
9/30	CD	10,010.00			
10/31	CD	7,150.00			
11/31	CD	4,290.00			
12/31	CD	4,290.00			
12/31	J	1,430.00			
		76,862.50			

#62 Carbonic Gas

1/31/54	CD	114.12	1/1/54	J	42.60
2/28	CD	92.76			
3/31	CD	103.98			
4/30	CD	111.00			
5/31	CD	124.80			
6/30	CD	234.00			
7/31	CD	273.84			
8/31	CD	291.60			
9/30	CD	235.02			
10/31	CD	145.80			
11/30	CD	103.98			
12/31	CD	107.46			
12/31	J	55.10			
		1,993 46			

#63 CROWNS

1/31/54	CD	446.40	
3/31	CD	446.40	
5/31	CD	446.40	
6/30	CD	667.60	
7/31	CD	888.10	
8/31	CD	888.10	
9/30	CD	446.40	
10/31	CD	446.40	
11/30	CD	446.40	
12/31	CD	446.40	
12/31	J	440.00	
		6,008 60	

#64 Cartons

1/31/54	CD	121.80	
2/28	CD	121.80	
3/31	CD	158.10	
4/30	CD	234.50	
5/31	CD	271.10	
6/30	CD	234.50	
7/31	CD	347.80	
8/31	CD	347.80	
9/30	CD	385.60	
10/31	CD	234.50	
11/30	CD	121.80	
12/31	CD	81.20	
		2,660.50	

#65 Plant Labor

1/31/54	CD	1,940.00			
2/28	CD	1,940.00			
3/31	CD	1,940.00			
4/30	CD	1,940.00			
5/31	CD	1,940.00			
6/30	CD	1,940.00			
7/31	CD	1,940.00			
8/31	CD	1,940.00			
9/30	CD	1,940.00			
10/31	CD	1,940.00			
11/30	CD	1,940.00			
12/31	CD	1,940.00			
		23,280 00			

#66 Rent

1/31/54	CD	275.00			
2/28	CD	275.00			
3/31	CD	275.00			
4/30	CD	275.00			
5/31	CD	275.00			
6/30	CD	300.00			
7/31	CD	300.00			
8/31	CD	300.00			
9/30	CD	300.00			
10/31	CD	300.00			
11/30	CD	300.00			
12/31	CD	300.00			
		3,475 00			

#67 Heat, Light, and Power

1/31/54	CD	96.00	1/1/54	J	96.00
2/28	CD	112.00			
3/31	CD	84.00			
4/30	CD	76.00			
5/31	CD	82.00			
6/30	CD	93.00			
7/31	CD	104.00			
8/31	CD	117.00			
9/30	CD	98.00			
10/31	CD	86.00			
11/30	CD	78.00			
12/31	CD	85.00			
12/31	J	94.00			
		1,205.00			

#68 Water

1/31/54	CD	28.00	
2/28	CD	28.00	
3/31	CD	28.00	
4/30	CD	30.00	
5/31	CD	32.00	
6/30	CD	36.00	
7/31	CD	40.00	
8/31	CD	40.00	
9/30	CD	40.00	
10/31	CD	34.00	
11/30	CD	32.00	
12/31	CD	32.00	
		400.00	

#69 Depreciation of Machinery

12/31/54	J	4,310.00	

#70 Machinery Repairs

3/31/54	CD	18.00	
6/30	CD	46.00	
9/30	CD	72.00	
12/31	CD	38.00	
12/31	J	178.00	
		352.00	

#71 Factory Insurance

12/31/54	J	500.00	

#72 Factory Supplies

2/28/54	CD	30.00	
5/31	CD	57.00	
7/31	CD	18.00	
9/30	CD	46.00	
10/31	CD	52.00	
		203 00	

#81 Sales Salaries and Commissions

1/31/54	CD	2,220.40			
2/28	CD	2,254.48			
3/31	CD	2,173.20			
4/30	CD	2,176.10			
5/31	CD	2,223.60			
6/30	CD	2,328.80			
7/31	CD	3,167.00			
8/31	CD	3,421.20			
9/30	CD	3,586.00			
10/31	CD	3,205.00			
11/30	CD	2,488.40			
12/31	CD	2,223.60			
		31,467.78			

#82 Gas, Oil, and Grease

1/31/54	CD	786.00	1/1/54	J	448.00
2/28	CD	812.00			
3/31	CD	806.00			
4/30	CD	984.00			
5/31	CD	1,015.00			
6/30	CD	1,020.00			
7/31	CD	1,243.00			
8/31	CD	1,431.00			
9/30	CD	1,428.00			
10/31	CD	1,198.00			
11/30	CD	897.00			
12/31	CD	809.00			
12/31	J	684.00			
		13,113 00			

#83 Drivers' Expenses

4/30/54	CR	42.00			
5/31	CR	115.00			
6/30	CR	365.00			
7/31	CR	328.00			
8/31	CR	409.00			
9/30	CR	112.00			
10/31	CR	55.00			
		1,426.00			

#84 Truck Repairs and Maintenance

2/28/54	CD	46.00	
4/30	CD	186.00	
6/30	CD	18.00	
8/31	CD	32.00	
10/31	CD	78.00	
11/30	CD	104.00	
12/31	CD	82.00	
		546.00	

#85 Depreciation of Delivery Equipment

12/31/54	J	2,412.00	

#86 Truck Licenses

11/30/54	CD	1,380.00	

#87 Truck Insurance

12/31/54	J	480.00	

#88 Advertising

1/31/54	CD	450.00	
2/28	CD	620.00	
3/31	CD	540.00	
4/30	CD	750.00	
5/31	CD	810.00	
6/30	CD	760.00	
7/31	CD	540.00	
8/31	CD	670.00	
9/30	CD	760.00	
10/31	CD	850.00	
11/30	CD	620.00	
12/31	CD	580.00	
		7,950.00	

#89 Depreciation of Coolers

12/31/54	J	1,950.00	

#90 Office Salaries

1/31/54	CD	1,080.00			
2/28	CD	1,080.00			
3/31	CD	1,080.00			
4/30	CD	1,080.00			
5/31	CD	1,080.00			
6/30	CD	1,080.00			
7/31	CD	1,080.00			
8/31	CD	1,080.00			
9/30	CD	1,080.00			
10/31	CD	1,080.00			
11/30	CD	1,080.00			
12/31	CD	1,080.00			
		12,960.00			

#91 Stationery, Supplies, and Postage

1/31/54	CD	18.50	1/1/54	J	11.75
2/28	CD	36.60			
3/31	CD	152.00			
4/30	CD	12.80			
5/31	CD	43.70			
6/30	CD	18.20			
7/31	CD	76.80			
8/31	CD	12.50			
9/30	CD	36.40			
10/31	CD	17.90			
11/30	CD	23.50			
12/31	CD	14.70			
		463.60			

#92 Depreciation of Office Equipment

12/31/54	J	198.00			

#93 Telephone and Telegraph

1/31/54	CD	18.00	1/1/54	J	18.00
2/28	CD	24.60			
3/31	CD	16.30			
4/30	CD	35.90			
5/31	CD	14.10			
6/30	CD	18.70			
7/31	CD	26.50			
8/31	CD	32.80			
9/30	CD	18.50			
10/31	CD	24.90			
11/30	CD	26.30			
12/31	CD	32.10			
12/31	J	28.60			
		317.30			

#94 Legal and Accounting

3/31/54	CD	1,200.00			
6/30	CD	650.00			
9/30	CD	1,800.00			
		3,650.00			

#95 Dues and Subscriptions

1/31/54	CD	50.00			
6/30	CD	75.00			
9/30	CD	18.00			
11/30	CD	12.00			
		155.00			

#96 General Insurance

12/31/54	J	787.06			

#97 State and Local Taxes

6/30/54	CD	895.00	1/2/54	J	900.00
8/31	CD	15.00			
12/31	CD	925.00			
		1,835.00			

#98 Social Security Taxes

1/31/54	CD	444.14	1/2/54	J	444.14
2/28	CD	78.60			
3/31	CD	79.11			
4/30	CD	585.39			
5/31	CD	77.94			
6/30	CD	78.64			
7/31	CD	592.14			
8/31	CD	92.91			
9/30	CD	89.11			
10/31	CD	367.53			
11/30	CD	73.12			
12/31	CD	52.17			
12/31	J	457.33			
		3,068.13			

#99 Miscellaneous

1/31/54	CD	17.50			
2/28	CD	18.10			
3/31	CD	27.80			
4/30	CD	19.00			
5/31	CD	34.60			
6/30	CD	81.40			
7/31	CD	12.70			
8/31	CD	41.80			
9/30	CD	12.50			
10/31	CD	17.40			
11/30	CD	46.60			
12/31	CD	40.00			
		369.40			

#102 Case and Bottle Expense

1/31/54	CR	7,984.00	1/1/54	J	300.00
1/31	CD	300.00			
2/28	CR	8,320.00			
3/31	CR	7,105.00			
3/31	CD	1,300.00			
4/30	CD	2,000.00			
4/30	CR	7,400.00			
5/31	CR	8,500.00			
6/30	CR	17,650.00			
6/30	CD	1,875.00			
7/31	CR	18,400.00			
8/31	CR	21,320.00			
8/31	CD	2,000.00			
9/30	CR	19,250.00			
10/31	CR	10,180.00			
10/31	CD	1,200.00			
11/31	CR	9,480.00			
12/31	CR	8,100.00			
12/31	J	360.00			
		153,724.00			

CASH RECEIPTS BOOK

December 1954

Date	Cash	Drivers Expenses	Cases and Bottles Purchased	Accounts Receivable	General Ledger Dr.	General Ledger Account	General Ledger Cr.	Soft Drink Sales	Cases and Bottles Sales	Cooler Rentals	Accounts Receivables
Dec. 1	488.90		324.00	176.00				512.00	320.00		156.90
2	512.10		308.50	143.50				488.00	305.00		171.10
3	473.50		310.00	158.00				492.00	307.50		142.00
4	503.60		296.50	172.00				497.60	311.00		163.50
6	426.20		347.50	145.60				454.40	284.00		180.90
7	487.00		315.50	152.40				476.00	297.50		181.40
8	463.50		302.00	187.60				492.00	307.50		153.60
9	420.00		349.00	204.00				496.00	310.00		167.00
10	445.00		355.00	186.10				505.60	316.00		164.50
11	467.70		306.00	175.00				477.60	298.50		172.60
13	445.60		297.00	164.40				449.60	281.00		176.40
14	396.70		340.50	184.80				482.40	301.50		138.10
15	474.90		357.50	146.50				506.40	316.50		156.00
16	454.20		334.00	172.40				489.60	306.00		165.00
17	524.50		336.50	144.50				494.40	309.00		202.10
18	499.00		317.50	142.00				500.00	312.50		146.00
20	411.90		284.00	186.90				446.40	279.00		157.40
21	501.00		318.50	176.00				516.00	322.50		157.00
22	525.00		322.00	144.00				502.40	314.00		174.60
23	479.90		319.50	142.00				494.40	309.00		138.00
27	473.60		284.50	161.50				489.60	306.00		124.00
28	652.90		346.50	183.00				612.00	382.50		187.90
29	691.30		328.00	215.60				652.00	407.50		175.40
30	867.00		372.50	524.60				801.60	501.00	255.00	206.50
31	434.00		327.50	313.60				568.00	355.00		152.10
	11,519.00		8,100.00	4,702.00				12,896.00	8,060.00	255.00	4,110.00

CASH DISBURSEMENTS BOOK

December 1954

Date	Payee	Cash: Check No.	Cash: Amount	Discount	General Ledger: Cr.	General Ledger: Acct.	General Ledger: Dr.	Production: No.	Production: Amount	Sell and Dist: No.	Sell and Dist: Amount	Admin: No.	Admin: Amount
Dec. 1	National Soft Drink Co.	2481	1,072.50					61	1,072.50				
1	Grant's Garage	2482	368.80							82	368.80		
3	Petty cash	2483	48.70					64	11.20			91	14.70
								63	6.40			99	16.40
4	Sundby's Repair Service	2484	38.00					70	38 00				
6	Wright Box & Carton Co.	2485	68.60	1.40				64	70.00				
8	National Soft Drink Co.	2486	1,072.50					61	1,072.50				
8	Local Water Corp.	2487	32.00					68	32.00				
10	Simmons Advertising Agency	2488	265.00							88	265.00		
10	S. D. Handy, Realtor	2489	300.00					66	300.00				
10	Liquid Gas & Supply Co.	2490	53 40					62	53 40				
11	Illinois Bell Telephone Co.	2491	32.10									93	32.10
14	Payroll	2492	2,695.91		332.69	33		65	970.00	81	1,518.60	90	540.00
15	King Crown & Bottlers Supply	2493	431.20	8.80				63	440.00				
15	National Soft Drink Co.	2494	1,072 50					61	1,072.50				
17	Central Power & Light	2495	85.00					67	85.00				
17	Grant's Garage	2496	252.20							82	252.20		
21	Henderson's Repair Service	2497	82.00							84	82.00		
22	National Soft Drink Co.	2498	1,072.50					61	1,072.50				
23	Simmons Advertising Agency	2499	315 00							88	315.00		
28	First National Bank	2500	608.84			33	556.67					98	52.17
29	Payroll	2501	2,026.78		188.22	33		65	970.00	81	705.00	90	540.00
30	Grant's Garage	2502	188.00							82	188.00		
30	Kleane Towel Service	2503	23.60									99	23.60
31	Liquid Gas & Supply Co.	2504	54.06					62	54.06				
			12,259.19	10.20	520.91		556 67		7,320.06		3,694.60		1,218.97
								61	4,290.00	81	2,223.60	90	1,080.00
								62	107.46	82	809.00	91	14.70
								63	446.40	84	82.00	93	32.10
								64	81.20	88	580.00	98	52.17
								65	1,940.00			99	40.00
								66	300.00				
								67	85.00				
								68	32.00				
								70	38.00				
									7,320.06		3,694.60		1,218.97

COMPOSITION OF PETTY CASH FUND

December 31, 1954

Pennies	27 loose and one roll of 25
Nickels	7 loose and two rolls of 20
Dimes	23 loose and two rolls of 50
Quarters	3 loose and one roll of 20
Dollar bills	14
Five-dollar bills	3

Expense vouchers

Jones Stationery Shop: office supplies	$ 3.68
Janitor and Restaurant Supply: sweeping compound	6.40
Postmaster: stamps	15.00

Check

One check payable to Cash, drawn 12/28/54 on First National Bank and signed by J. Landgren; amount $25.00

BANK STATEMENT, GENERAL CASH ACCOUNT

December 1954

FIRST NATIONAL BANK
Someville, Illinois

Statement of account with Better Bottling Company

Checks			Deposits	Date	December 31, 1954 Balance
Forward				11/30/54	34,975.98
1,072.50	48.40		511.00	12/1	34,366.08
345.00	26.50		488.90	12/2	34,483.48
			512.10	12/3	34,995.58
368.80	48.70		977.10	12/6	35,555.18
			426.20	12/7	35,981.38
			487.00	12/8	36,468.38
68.60	1,072.50	38.00	463.50	12/9	35,752.78
			420.00	12/10	36,172.78
265.00	32.00		912.70	12/13	36,788.48
			445.60	12/14	37,234.08
300.00	1,072.50	2,695.91	396.70	12/15	33,562.37
			474.90	12/16	34,037.27
32.10			454.20	12/17	34,459.37
			1,023.50	12/20	35,482.87
85.00			411.90	12/21	35,809.77
252.20	53.40		501.00	12/22	36,005.17
			525.00	12/23	36,530.17
82.00			479.90	12/27	36,928.07
			473.60	12/28	37,401.67
608.84			652.90	12/29	37,445.73
2,026.78			691.30	12/30	36,110.25
188.00			867.00	12/31	36,789.25

Paid checks returned with the bank statement included the following:

No.	Payee	Amount	No.	Payee	Amount
2475	National Soft Drink Co.	$1,072.50	2489	S. D. Handy, Realtor	$ 300.00
2478	Liquid Gas & Supply Co.	48.40	2486	National Soft Drink Co.	1,072.50
2479	Simmons Advertising Agency	345.00	2492	Payroll	2,695.91
2480	Henderson's Repair and Wrecker Service	26.50	2491	Illinois Bell Telephone Company	32.10
2482	Grant's Garage	368.80	2495	Central Power and Light Co.	85.00
2483	Petty Cash	48.70	2496	Grant's Garage	252.20
2485	Wright Box & Carton Co.	68.60	2490	Liquid Gas and Supply Co.	53.40
2481	National Soft Drink Co.	1,072.50	2497	Henderson's Repair and Wrecker Service	82.00
2484	Sundby Repair Service	38.00	2500	First National Bank	608.84
2488	Simmons Advertising Agency	265.00	2501	Payroll	2,026.78
2487	Local Water Corp.	32.00	2502	Grant's Garage	188.00

BANK STATEMENT, GENERAL CASH ACCOUNT

January 1-14, 1955

FIRST NATIONAL BANK
Someville, Illinois

Statement of account with Better Bottling Company

Checks			Deposits	Date	January 15, 1955 Balance
Forward				12/31/54	36,789.25
94.00	431.20		434.00	1/4/55	36,698.05
315.00	1,072.50		630.85	1/5	35,941.40
			385.70	1/6	36,327.10
360.00	684.00		612.40	1/7	35,895.50
			491.02	1/8	36,386.52
23.60	1,072.50		505.00	1/10	35,795.42
440.00			435.75	1/12	35,791.17
			366.77	1/13	36,157.94
28.60	178.00	54.06	388.70	1/14	36,285.98

Paid checks returned with the bank statement included the following:

No.	Payee	Amount	No.	Payee	Amount
2505	Local Light and Power Co.	94.00	2509	Grant's Garage	684.00
2493	King Crown & Bottlers Supply	431.20	2503	Kleane Towel Service	23.60
2499	Simmons Advertising Agency	315.00	2498	National Soft Drink Co.	1,072.50
2494	National Soft Drink Co.	1,072.50	2508	Hoskinson Co.	440.00
2507	Durable Bottle Co.	360.00	2511	Bell Telephone Co.	28.60
			2512	Monarch Machinery Co.	178.00
			2504	Liquid Gas & Supply Co.	54.06

BANK RECONCILIATION, GENERAL CASH ACCOUNT

November 30, 1954

BETTER BOTTLING COMPANY
BANK RECONCILIATION

11/30/54

Balance per bank statement		$34,975.98
Less outstanding checks:		
No. 2475	$1,072.50	
2478	48.40	
2479	345.00	
2480	26.50	1,492.40
		33,483.58
Deposit in transit		511.00
Balance per books		$33,994.58

ACCOUNTS RECEIVABLE TRIAL BALANCE

December 31, 1954

Corner Grocery	$ 488.50
General Food Stores	878.50
Andy's Hamburger Stand	124.00
Jemison Service Stations	846.00
Wright's Vending Service	294.00
Stevenson's Restaurant	421.00
Downtown Pharmacy	386.50
Kelly's Drive-In	976.50
Morrell & Morrell	478.00
E. and F. Cafe	358.00
Broadbent Employees' Association	864.00
Elks Club	1,280.00
Y.M.C.A.	476.00
Student Union	924.00
Morgan Recreation Hall	684.00
All other	7,241.50
	$16,720.50

SELECTED ACCOUNTS FROM CUSTOMERS' LEDGER

ANDY'S HAMBURGER STAND

Date	Explanation	Debit	Credit	Balance
11/30/54	Balance			18.50
12/6	Inv. No. 715	16.00		34.50
12/14	Inv. No. 764	35.00		69.50
12/20	Inv. No. 813	18.50		88.00
12/27	Inv. No. 881	36.00		124.00
1/3/55	Check		100.00	24.00

KELLY'S DRIVE-IN

Date	Explanation	Debit	Credit	Balance
11/30/53	Balance			463.50
12/2	Inv. No. 647	165.00		628.50
12/9	Inv. No. 731	132.50		761.00
12/16	Inv. No. 782	104.50		865.50
12/17	Check		225.00	640.50
12/23	Inv. No. 840	214.00		854.50
12/30	Inv. No. 910	122.00		976.50

DOWNTOWN PHARMACY

Date	Explanation	Debit	Credit	Balance
11/30/54	Balance			212.50
12/1	Inv. No. 638	87.00		299.50
12/4	By check		212.50	87.00
12/15	Inv. No. 771	194.00		281.00
12/29	Inv. No. 901	105.50		386.50

INVENTORIES

December 31, 1953

Soft-Drink syrup			
96 drums (55 gallons each)	5,280	1.30	$ 6,864.00
Crowns	8,500 gross	.22	1,870.00
Bottles and cases—filled			
Product	1,538 cases	.80	1,230.40
Cases and bottles	1,538 cases	.50	769.00
Bottles and cases—empty			
Complete cases	4,316 cases	.50	2,158.00
Bottles—used	1,500 bottles	.02	30.00
Bottles—new	50 gross	6.00	300.00
Cartons	14,500	35.00 M	507.50
Caustic soda			
3—100 lb. drums	300 pounds	5.00 drum	15.00
Carbonic gas	2,100 pounds	.06	126.00
			$13,869.90

INVENTORIES

December 31, 1954

Soft-Drink syrup				
143 drums (55 gallons each)	7,865			
1 drum partially filled	40	7,905	1.30	$10,276.50
Crowns	9,250 gross		.22	2,035.00
Bottles and cases—filled				
Product	1,786 cases		.80	1,428.80
Cases and bottles	1,786 cases		.50	898.00
Bottles and cases—empty				
Complete cases	4,687 cases		.50	2,343.50
Bottles—used	2,300 bottles		.02	460.00
Cartons	9,000		35.00 M	315.00
Caustic soda				
$7\frac{1}{2}$ 100-lb. drums	750 lb.		.05	37.50
Carbonic gas	2,006 lb.		.06	120.36
				$17,914.66

ACCOUNTS PAYABLE

December 31, 1954

Durable Bottle Co.: 60 gross	$ 360.00	received 1/3/55, F.O.B. sh. pt.
Local Light and Power Co.	94.00	for December, 1954
Grant's Garage and Service Station	684.00	to 12/28/54
National Soft-Drink Company: 1,100 gal.	1,430.00	received 12/31/54
Liquid Gas & Supply Co.	55.10	for shipment of 12/18/54
Bell Telephone Co.	28.60	to 12/20/54
Monarch Machinery Co.: repairs	178.00	as of 12/10/54
Hoskinson Co.: 2,000 gross crowns	440.00	received 12/29/54
	$3,269.70	

BETTER BOTTLING COMPANY
PREPAID INSURANCE

December 31, 1954

Company	Policy Number	Property	Risk	Cover-age	Cost	Term	Date	Prepaid 12/31/53	Paid in 1954	Amortized in 1954	Prepaid 12/31/54
Western[1]	A-172-5	Building contents	Fire & EC	60,000	1,500.00	3 yrs.	8/28/53	1,333.33		500.00	833.33
Western[2]	LO-3486	Trucks	F, T, & C	Fleet	480.00	1 yr.	3/2/54	80.00	480.00	480.00	80.00
Dealers Mutual[3]	KT 971		Product Liability		77.00	1 yr.	6/1/54	15.60	7.72	23.32	
									79.20	60.00	19.20
Dealers Mutual[4]	KP 1864		Comp. liab. & WC		635.50	1 yr.	6/1/54	260.75	699.50	703.74	256.51
								1,689.68	1,266.42	1,767.06	1,189.04

[1]Three-year policy on building contents; rate, $25.00 a thousand.

[2]One-year policy on trucks, fleet not to exceed nine, at $60 a truck covering fire, theft, and collision.

[3]One-year policy against product liability; rate, $.22 a thousand of sales. Estimated premium paid in advance and ajusted to insurance audit at end of policy year. Estimated sales for policy year beginning 6/1/54, $360,000.

[4]One year comprehensive policy against public liability and property damage, unknown hazard, and workmen's compensation. Premium based on:

$27.00 a year for each truck

.27 per $100 of drivers' wages (estimated at $30,000 for policy year beginning 6/1/54) to be adjusted to actual at end of policy year.

.60 per $100 of total payroll (estimated at $67,100 for policy year beginning 6/1/54) to be adjusted to actual at end of policy year.

Unexpired premium at 12/31/54 composed of:

5/12 of $216	$ 90.00
$81.00 less (.27 times $20,420 paid)	25.87
$390.00 less (.60 times $41,560 paid)	140.64
	$256.51

PAYROLLS

Employee	Salary	Commission	Total	F.I.T.	O.A.B.	Other	Net	Check No.
			December 15, 1954					
John Landgren	250.00		250.00	28.80			221.20	1417
Jack Nelson	225.00		225.00	33.90			191.10	1418
J. W. Moffitt	200.00		200.00	18.80			181.20	1419
Caroline Anderson	90.00		90.00	12.60	1.35		76.05	1420
L. T. Hare	165.00		165.00	11.00			154.00	1421
Fred Wolf	150.00		150.00	13.30	2.25		134.45	1422
T. L. Baer	110.00		110.00		1.65		108.35	1423
E. R. Beaver	110.00		110.00	5.50	1.65		102.85	1424
Roger Clarke	100.00		100.00	3.50	1.50		95.00	1425
Marion Lawrence	80.00		80.00	5.10	1.20		73.70	1426
Gwendolyn Williams	80.00		80.00	10.60	1.20		68.20	1427
Steven Purdy	100.00		100.00	14.60	1.50		83.90	1428
Joe Broome	75.00		75.00		1.12		73.88	1429
Frank Bigger	60.00	121.70	181.70	25.30	2.73		153.67	1430
Victor Small	60.00	98.60	158.60	26.00	2.37		130.23	1431
C. V. Sooner	60.00	118.40	178.40	18.90	2.67		156.83	1432
S. O. Grosse	60.00	75.10	135.10	10.10	2.02		122.98	1433
M. T. Kegg	60.00	116.00	176.00	13.40	2.64		159.96	1434
J. F. Jackson	60.00	118.80	178.80	24.50	2.67		151.63	1435
R. T. Lewis	60.00	124.70	184.70	20.50	2.77		161.43	1436
George Abbott	60.00	40.30	100.30	3.50	1.50		95.30	1437
	2,215.00	813.60	3,028.60	299.90	32.79		2,695.91	
			December 31, 1954					
John Landgren	250.00		250.00	28.80			221.20	1438
Jack Nelson	225.00		225.00	33.90			191.10	1439
J. W. Moffitt	200.00		200.00	18.80			181.20	1440
Caroline Anderson	90.00		90.00	12.60	1.35		76.05	1441
L. T. Hare	165.00		165.00	11.00			154.00	1442
Fred Wolf	150.00		150.00	13.30	2.25		134.45	1443
T. L. Baer	110.00		110.00		1.65		108.35	1444
E. R. Beaver	110.00		110.00	5.50	1.65		102.85	1445
Roger Clarke	100.00		100.00	3.50	1.50		95.00	1446
Marion Lawrence	80.00		80.00	5.10	1.20		73.70	1447
Gwendolyn Williams	80.00		80.00	10.60	1.20		68.20	1448
Steven Purdy	100.00		100.00	14.60	1.50		83.90	1449
Joe Broome	75.00		75.00		1.12		73.88	1450
Frank Bigger	60.00		60.00	1.10	.90		58.00	1451
Victor Small	60.00		60.00	6.60	.90		52.50	1452
C. V. Sooner	60.00		60.00		.90		59.10	1453
S. O. Grosse	60.00		60.00		.90		59.10	1454
M. T. Kegg	60.00		60.00		.90		59.10	1455
J. F. Jackson	60.00		60.00	1.10	.90		58.00	1456
R. T. Lewis	60.00		60.00		.90		59.10	1457
George Abbott	60.00		60.00	1.10	.90		58.00	1458
	2,215.00		2,215.00	167.60	20.62		2,026.78	

INFORMATION SUPPLIED BY OFFICE MANAGER

During the course of your examination you find it necessary to ask various questions of Mr. J. W. Moffitt, the office manager. Some of these questions are of a routine nature; others result in bringing out information essential to completion of the examination. The following paragraphs represent replies to certain of these more important questions. You should take them into consideration in preparing your work papers and adjustments.

"Yes, the general ledger is in balance. So is the accounts receivable ledger. I have made all the regular adjustments except the one for federal income taxes which you auditors always make yourselves."

"Yes, there are a few bad accounts. Included in the 'all other' accounts receivable are accounts amounting to $285.00 that are uncollectible. Mr. Landgren and I just went over those accounts the other day." (He supplies you with a list of these accounts; the list has been initialed by Mr. Landgren.)

"We have not made any provision for accrued commissions to truck drivers. It takes me about two weeks to figure up the commissions earned each month so we pay the commissions for each month on the fifteenth of the following month. We never have accrued these commissions at the end of the year and do not figure it is worth while."

"Sure, we value our bottled inventory at selling price. We always have. This question comes up every year when you fellows come around. You see, we carry only a small finished-goods inventory. It is readily salable and as good as cash. Furthermore, it is almost impossible to tell exactly what it cost, so we value it at selling price which we know we will get for it."

"I worked out that insurance schedule myself. There may be a few minor errors in it but it is substantially correct. Unless you find some big errors I suggest you let them pass as they will all work themselves out next year."

"Yes, we bought a new truck this year. It listed at $3,850 and we got $1,400 for our old number one which we traded in on the new one. I used the income tax method of recording the trade so our books will agree with the tax return. We think that is the best procedure for a small company like ours. You can check the invoice for the allowance they gave us on the old truck and for the cost of the new one."

WORK SHEETS AND OTHER MATERIAL FROM AUDIT WORK PAPER FILES

TRIAL BALANCE PER AUDIT

December 31, 1953

BETTER BOTTLING COMPANY
TRIAL BALANCE

12/31/53

11	Petty Cash	100.00	
12	Cash—General	27,765.42	
13	Payroll Account	300.00	
16	Accounts Receivable	10,171.50	
18	Inventories	13,869.90	
19	Unexpired Insurance	1,689.68	
20	Machinery and Equipment	43,100.00	
21	Accrued Depreciation—Machinery and Equipment		14,707.00
22	Delivery Equipment	25,520.00	
23	Accrued Depreciation—Delivery Equipment		6.512.00
24	Office Furniture and Equipment	1,980.00	
25	Accrued Depreciation—Office Furniture and Equipment		557.00
26	Coolers	19,500.00	
27	Accrued Depreciation—Coolers		4,875.00
31	Accounts Payable		2,301.35
32	Employees Taxes Withheld		489.98
34	Accrued Social Security Taxes		444.14
35	Accrued State and Local Taxes		900.00
36	Federal Income Tax Accrued		7,500.00
41	Capital Stock		75,000.00
42	Earned Surplus		13,227.23
51	Soft Drink Sales		228,842.00
52	Case and Bottle Sales		143,030.00
53	Cooler Rentals		2,100.00
54	Discounts Earned		118.60
61	Soft Drink Syrup	70,972.00	
62	Carbonic Gas	1,920.52	
63	Crowns	5,674.40	
64	Cartons	2,584.00	
65	Plant Labor	22,360.00	
66	Rent	3,300.00	
67	Heat, Light, and Power	1,122.00	
68	Water	396.00	
69	Depreciation of Machinery	4,310.00	
70	Machinery Repairs	856.00	
71	Factory Insurance	500.00	
72	Factory Supplies	185.00	
81	Sales Salaries and Commissions	30,919.08	
82	Gas, Oil, and Grease	12,084.00	
83	Drivers Expenses	895.00	
84	Truck Repairs and Maintenance	1,412.00	
85	Depreciation of Delivery Equipment	2,412.00	
86	Truck Licenses	1,260.00	
87	Truck Insurance	460.00	
88	Advertising	7,635.00	
89	Depreciation of Coolers	1,950.00	
90	Office Salaries	12,960.00	
91	Stationery, Supplies, and Postage	465.00	
92	Depreciation of Office Equipment	198.00	
93	Telephone and Telegraph	284.00	
94	Legal and Accounting	4,248.00	
95	Dues and Subscriptions	148.00	
96	General Insurance	685.10	
97	State and Local Taxes	900.00	
98	Social Security Taxes	2,408.15	
99	Miscellaneous	465.00	
101	Uncollectible Accounts	3,426.00	
102	Bottles and Cases Purchased	149,713.55	
103	Federal Income Taxes	7,500.00	
		$500,604.30	$500,604.30

REVIEW OF INTERNAL CONTROL

BETTER BOTTLING COMPANY

Revised to December 31, 1954

The office staff consists of the following:

John Landgren	General manager
J. W. Moffitt	Office manager and accountant
Caroline Anderson	Secretary and accountant

Petty Cash. A petty cash fund of $100 under the control of Miss Anderson is maintained on an imprest basis. All petty cash disbursement vouchers must be approved by Mr. Moffitt. Reimbursement checks are signed by Mr. Landgren who reviews the disbursement vouchers at that time.

General Cash. The general cash is kept on deposit at the First National Bank. Disbursement checks are prepared by Mr. Moffitt but require Mr. Landgren's signature. He reviews the invoices to be paid with each check as he signs it.

Cash collected by the truck drivers each day is checked in to Miss Anderson. She also opens the mail, preparing a list of all mail receipts. She combines all cash received each day and deposits it to the company's account the following morning. Occasionally she leaves the day's receipts in the bank's night depository on her way home from work. The drivers' reports and the list of mail receipts are given to Mr. Moffitt for entry in the cash receipts book.

The monthly bank statement is given to Mr. Moffitt unopened as received by mail. He prepares the monthly bank reconciliations.

Payrolls. All employees are on a monthly salary rather than an hourly rate basis of pay. Absences are reported to Mr. Landgren by the plant foreman. All hiring and firing is done by Mr. Landgren who also approves raises, etc. The semimonthly payroll is prepared by Moffitt a day or so in advance and submitted to Landgren for approval together with a check drawn on the general cash account for the net amount of the payroll. This check is then deposited in the payroll bank account. Checks drawn against the payroll account are prepared and signed by Moffitt. He also reconciles the payroll bank account.

Commissions earned by the truck drivers are calculated by Mr. Moffitt on a monthly basis and added to their first pay check of the following month.

Sales. With a few exceptions, sales are made by truck drivers as they serve their routes. For each sale, cash or charge, a sales ticket is made out by the driver, the original of which is given to the customer, and the duplicate retained by the driver. For charge sales the customer's signature is obtained on the sales ticket. Sales tickets and cash collections are turned in to Miss Anderson each day when the drivers account for the product taken out that day. She summarizes the day's sales and receipts on a sales summary which is then given to Mr. Moffitt for entry.

Accounts Payable. No accounts payable ledger is used. As invoices are paid they are charged to appropriate accounts through the cash disbursements book. At the end of each month Mr. Moffitt lists the unpaid invoices and records them by journal entry. This entry is then reversed the first day of the following month.

Product Control. Mr. Moffitt keeps a running inventory of the product on a control sheet. The plant foreman prepares a record of each day's production

which is forwarded to Moffitt the following morning. From the drivers' reports Miss Anderson prepares her summary of sales which shows sales by bottle size and flavor. These two reports provide the data for entries to the product control sheet. Mr. Landgren reviews this control sheet frequently in order to schedule production so as not to overstock or run short of product.

Inventory. A physical inventory is taken at least once a week to tie in with the product control sheet. Mr. Handy, the plant foreman, supervises the inventory taking and is assisted by the plant workers. As the product and raw materials are few in number and easy to count, no inventory tags are used. Counts are entered directly on inventory lists prepared in advance. All items are counted and recorded by two crews operating independently. Handy then compares the counts, checks out any differences, initials the final copy, and sends it to Mr. Moffitt for pricing. Footings and extensions are calculated by Miss Anderson for the month-end inventories as these are recorded by adjusting entry on a work sheet from which monthly financial statements are prepared.

Bottles and Cases. In addition to the price of the product, customers are charged for bottles and cases at two cents a bottle and two cents a case. These prices are well below the cost of new bottles and cases to the company. When a customer returns empties he is given credit at the original price against additional purchases, or a cash refund if no purchases are made.

The Bureau of Internal Revenue accepts for tax purposes a method of accounting for bottles and cases that includes charges to customers for bottles and cases as if they were sales and treatment of both returns and the cost of new bottles and cases as a part of purchases. All bottles and cases on hand at December 31 are inventoried and considered in determining cost of goods sold. This tends to overstate both sales and cost of goods sold to some extent but as returns of empties almost equal sales of full cases the overstatement is not material.

Under this system, no charge for depreciation or breakage of bottles and cases is recorded; the difference between the cost of bottles and cases at the beginning of the year plus those purchased during the year and the cost of bottles and cases on hand at the end of the year becomes the expense of using bottles and cases for the year.

Miscellaneous. With the exceptions of any records previously described as prepared by Miss Anderson, all accounting work is done by Mr. Moffitt. He enters sales, cash receipts, cash disbursements, and journal entries, keeps the general and accounts receivable ledgers, and prepares monthly statements for Mr. Landgren and the board of directors.

BETTER BOTTLING COMPANY

EXCERPTS FROM MINUTES OF MEETINGS

1954

Annual Meeting of Stockholders 1/10/54

The following were elected to the Board of Directors to serve without pay for a term of one year:

George B. Clark
John F. Clark
Ronald B. Clark

Meeting of Board of Directors 1/10/54

The following were elected to the positions indicated:

George B. Clark	President
Ronald B. Clark	Vice President
John F. Clark	Secretary-Treasurer

Resolved that Mr. John Landgren be appointed general manager for a period of three years at an annual salary of \$6,000 plus a bonus of 5% of the net income for each year after income taxes and this bonus have been provided for as calculated by the company's auditors in their annual examination.

Resolved that the firm of Check and Prove, CPA's, be retained to make the annual audit for 1954.

Meeting of the Board of Directors 5/1/54

Resolved that Mr. John Landgren be authorized to enter into a new lease agreement in the name of the company for use of the present building at an annual rental of \$3,600 to run for ten years from June 1, 1954.

Meeting of Board of Directors 10/31/54

Resolved that a dividend be declared and paid in the amount of ten per cent on the outstanding stock November 15, 1954.

CAPITAL STOCK AND EARNED SURPLUS ANALYSIS

FROM PERMANENT FILE

BETTER BOTTLING COMPANY
CAPITAL STOCK AND EARNED SURPLUS

Permanent File

Capital Stock

5/15/50	750 shares of $100 par value common stock issued at par for cash	$75,000.00

Certificates issued as follows:

#1	George B. Clark	250 shares	$25,000
2	John F. Clark	250 shares	25,000
3	Ronald B. Clark	250 shares	25,000
			$75,000

Earned Surplus

12/31/50	Net loss for the year	$ (312.80)
12/31/51	Net income for the year	6,412.50
		6,099.70
12/31/52	Net income for the year	14,627.53
		20,727.23
11/15/53	Dividends paid	7,500.00
		13,227.23
12/31/53	Net income for the year	17,482.80
		30,710.03

BETTER BOTTLING COMPANY
DEPRECIATION SCHEDULES

Description	Date Purchased	Cost	1950	1951	1952	1953	1954	1955	1956
Machinery and Equipment (10%)									
Bottle washer	1950	22,000	1,100	2,200	2,200	2,200			
Premixer, filler, and crowner	1950	9,500	475	950	950	950			
Bottle line and assembly table	1950	1,820	91	182	182	182			
Water softener (tank and filters)	1951	2,400		120	240	240			
De-aerator equipment	1950	1,680	84	168	168	168			
Synchrometer	1950	2,520	126	252	252	252			
Air compressor	1951	880		44	88	88			
Mechanical lifts 3 at $400	1950	1,200	60	120	120	120			
Pallets 30 at $20	1950	600	30	60	60	60			
Pallets 20 at $25	1951	500		25	50	50			
Totals		43,100	1,966	4,121	4,310	4,310			
Accrued at end of preceding year				1,966	6,087	10,397			
Accrued at end of year			1,966	6,087	10,397	14,707			

Description	Date Purchased	Cost	1950	1951	1952	1953	1954	1955	1956
Delivery Equipment (10%)									
International truck (#1)	1950	3,640	182	364	364	364			
International truck (#2)	1950	3,640	182	364	364	364			
International truck (#3)	1950	3,640	182	364	364	364			
Chevrolet truck (#4)	1950	2,600	130	260	260	260			
Chevrolet truck (#5)	1951	2,600		130	260	260			
Chevrolet truck (#6)	1952	2,800			140	280			
International truck (#7)	1952	3,800			190	380			
Chevrolet truck (#8)	1953	2,800				140			
Totals		25,520	676	1,482	1,942	2,412			
Accrued at end of preceding year				676	2,158	4,100			
Accrued at end of year			676	2,158	4,100	6,512			

Description	Date Purchased	Cost	1950	1951	1952	1953	1954	1955	1956
Office Furniture and Equipment (10%)									
Desks: 4 at $80	1950	320	16	32	32	32			
Files: 4 at $75	1950	300	15	30	30	30			
6 at $80	1952	480			24	48			
Chairs: 6 at $40	1950	240	12	24	24	24			
Typewriters: 2 at $130	1950	260	13	26	26	26			
Adding machine	1950	180	9	18	18	18			
Coin counter	1952	200			10	20			
Totals		1,980	65	130	164	198			
Accrued at end of preceding year				65	195	359			
Accrued at end of year			65	195	359	557			
Coolers (10%)									
60 at $200 25 at $300	1951	19,500		975	1,950	1,950			
Totals		19,500		975	1,950	1,950			
Accrued at end of preceding year					975	2,925			
Accrued at end of year				975	2,925	4,875			

BETTER BOTTLING COMPANY
PAYROLL BANK ACCOUNT RECONCILIATION

December 31, 1954

Balance per bank statement		$630.20
Less outstanding checks		
No. 1442	154.00	
1451	58.00	
1454	59.10	
1455	59.10	330.20
Balance per books		300.00

ACCOUNTS RECEIVABLE CONFIRMATIONS RECEIVED WITH EXCEPTIONS

Messrs Check and Prove
One North LaSalle Street
Chicago, Illinois

No. 3

We confirm the correctness of a debit balance of $124.00 in our account on the books of the Better Bottling Company as of 12/31/54 with the exceptions, if any, stated below.

Signed Andy's Hamburgers
By Byron Anderson

Exceptions (please explain in detail)

We don't owe that much because we sent you a check for $100 December 31.

Messrs. Check and Prove
One North LaSalle Street
Chicago, Illinois

No 8

We confirm the correctness of a debit balance of $976.50 in our account on the books of the Better Bottling Company as of 12/31/54 with the exceptions, if any, stated below.

Signed Ross Kelly
By

Exceptions (please explain in detail)
We returned 150 cases of empties to you in our truck December 12th We should get $75.00 credit for this which you have not given us. We have a receipt signed by your plant foreman.

Messrs. Check and Prove
One North LaSalle Street
Chicago, Illinois

No. 7

We confirm the correctness of a debit balance of \$386.50 in our account on the books of the Better Bottling Company as of 12/31/54 with the exceptions, if any, stated below.

Signed Downtown Pharmacy
By Wm. Capener

Exceptions (please explain in detail)
Your statement shows a charge of \$194.00 on Dec. 15 Our records show we received only 80 cases and returned 20 empties for a net charge of \$94.00